PUBLIC UTILITY HOLDING COMPANY ACT AMENDMENTS

HEARINGS
BEFORE THE
SUBCOMMITTEE ON SECURITIES
OF THE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
NINETY-SEVENTH CONGRESS
SECOND SESSION
ON

S. 1869, S. 1870 and S. 1871
TO AMEND THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
AND

S. 1977
TO REPEAL THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

APRIL 27, JUNE 8 AND 10, 1982

Printed for the use of the
Committee on Banking, Housing, and Urban Affairs

[97–62]

U.S. GOVERNMENT PRINTING OFFICE
98-071 O WASHINGTON : 1982

5241-38

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CONTENTS

TUESDAY, APRIL 27, 1982

Page

Opening statement of Senator D'Amato........ 1
Statement of Senator Schmitt........ 185
Senate bills being considered:
  S. 1869........ 186
  S. 1870........ 204
  S. 1871........ 213
  S. 1977........ 215
Comments from the Department of Energy........ 219

WITNESSES

Bennett J. Johnston, U.S. Senator from the State of Louisiana........ 2
  SEC letter to Senator D'Amato expressing the Commission's views on introduced bills........ 3
  Prepared statement........ 4
Tom Corcoran, Representative in Congress from the State of Illinois........ 7
  Prepared statement........ 8
    Financial condition of the utility industry........ 8
    Survey of utilities and State commissions........ 9
    Administration and House activities relating to the Holding Company Act........ 9
    Diversification........ 10
    Investors flee utility industry........ 12
    Respondents to October 27, 1981, letter, questionnaire regarding the Public Utility Holding Company Act:
      Utility companies:
        CP National........ 16
        Virginia Electric & Power Co........ 17, 144
        Public Service Company of Oklahoma........ 18, 149
        Public Service Indiana........ 19, 50
        Northern Indiana Public Service Co........ 20
        South Carolina Electric & Gas Co........ 21
        Pacific Gas & Electric Co........ 22, 78
        Mississippi Power & Light Co........ 24, 128
        TECO Energy Inc........ 25
        Kansas City Power & Light Co........ 26
        Bay State Gas Co........ 27
        Wisconsin Power & Light Co........ 28, 41
        Middle South Utilities Inc........ 29, 73
        Washington Gas Light Co........ 30
        Northern States Power Co........ 37
        Central Illinois Public Service Co........ 42
        Ohio Edison Co........ 44
        Central & South West Corp........ 45
        Texas Utilities Co........ 49
        Eastern Utilities Associates........ 52
        Puget Sound Power & Light Co........ 53
        Hawaiian Electric Co. Inc........ 55
        Central Illinois Light Co........ 56
        Houston Industries Inc........ 57
        American Electric Power Co. Inc........ 59

Tom Corcoran, Representative in Congress from the State of Illinois—Continued
- Prepared statement—Continued
  - Respondents to October 27, 1981, letter, questionnaire regarding the Public Utility Holding Company Act—Continued
    - Utility companies—Continued

Page

- New England Electric ... 62
- Baltimore Gas and Electric ... 67
- Carolina Power & Light Co ... 69
- National Fuel Gas Co ... 71
- General Public Utilities Corp ... 72
- Washington Water Power Co ... 76
- Intermountain Gas Co ... 86
- Potomac Electric Power Co ... 88
- Columbia Gas System ... 91
- Atlantic Electric ... 92
- Montana Power Co ... 100
- Public Service Electric & Gas Co ... 103
- Consumers Power Co ... 105
- Eastern Gas & Fuel Associates ... 107
- Consolidated National Gas Co ... 108
- Wisconsin Electric Power Co ... 114
- Consolidated Edison Co. of New York ... 118
- Peoples Energy Corp ... 121
- Illinois Power Co ... 124
- Iowa Resources Inc ... 126
- Duquesne Light Co ... 136
- Minnesota Power ... 138
- Northeast Utilities ... 139
- Montana-Dakota Utilities Co ... 141
- Bangor Hydro-Electric Co ... 143
- Commonwealth Edison ... 146
- Kansas City Power & Light Co ... 148
- Allegheny Power System, Inc ... 150

Public utility commissions:

- Arkansas ... 151
- Florida ... 152
- Washington ... 154
- Rhode Island ... 155
- Nevada ... 156
- Iowa ... 157
- Connecticut ... 158
- Illinois ... 160
- Georgia ... 162
- Indiana ... 163
- Texas ... 164
- Delaware ... 167
- Kansas ... 169
- Virginia ... 172
- Maryland ... 174
- Oregon ... 175
- Wisconsin ... 176
- Idaho ... 177
- Colorado ... 179
- Hawaii ... 180
- Wyoming ... 182

Diversification into non-utility businesses ... 183

W. J. Tauzin, Representative in Congress from the State of Louisiana ... 234
- Unnecessary regulations ... 234
- Repeal justified ... 235
- Prepared statement ... 237
  - Simplification ... 238
  - Registration ... 239
  - Business regulation ... 239

Solomon Freedman, Counsel, Davis & Cox, Washington, D.C. ... 242
- Structure of the Act ... 242
- Prepared statement ... 244
  - Background ... 244

Solomon Freedman, Counsel, Davis & Cox, Washington, D.C—Continued
Page
  Prepared statement—Continued
    The structure of the Act 244
  Administration of the Act 247
Charles Benore, first vice president; Paine, Webber, Mitchell & Hutchins, Inc., New York 249
  Declining financial integrity 249
  Financial flexibility 251
  Prepared statement 252
    Exhibit 1—Upgradings and downgradings of bonds of utility and industrial firms, 1971-1980 256
    Exhibit 2—Bond financing by electric utilities in 1981 by term 257
    Exhibit 3—Average prices of Standard & Poors 258
    Exhibit 4—Effect of a declining price-to-common equity book value per share ratio on earnings per share 259
    Duties and professional qualifications 260
Panel discussion:
  Retain certain provisions 263
  Diversification as a distraction 264
Floyd W. Lewis, chairman of the board, Middle South Utilities, Inc., on behalf of Edison Electric Institute 266
  Exempt status 267
  Management flexibility 269
  Prepared statement 272
Eugene Luntey, president and chief executive officer, Brooklyn-Union Gas Co., on behalf of American Gas Association, accompanied by Richard Rosen, special consultant to AGA; and Andrea Hilliar, AGA manager and counsel of legislative and regulatory affairs 279
  Prepared statement 279
    Introduction 279
    Repeal of PUHCA and the need for meaningful regulatory reform 280
    Why PUHCA should be repealed 281
    Effect of total repeal 281
    Conclusion 283
Alan Richardson, legislative director and counsel, American Public Power Association, accompanied by George Spiegel, Esq., Spiegel & McDiarmid 283
  Critical elements 283
  Basic arguments for repeal 285
  Diversification poses some risks 286
  Prepared statement 287
    The Act is not redundant 287
    Regulation of affiliate transactions 288
    The "regulatory burden" argument 290
    Municipal utility interest 290
    Utility diversification 291
    Specific legislative proposals 293
    S. 1977 293
    S. 1869 293
    S. 1870 293
    Conclusion 295
    Exhibit A—Public Utility Holding Company Act 295
    Exhibit B—National Association of Regulatory Utility Commissioners, 1972 Report of the Ad Hoc Committee on Non-utility Investments 297
    Exhibit C—State of Wisconsin, Public Service Commission, letter to John S. R. Shad, Chairman SEC, from Stanley York, chairman 316
    Exhibit D—U.S. Department of Energy, Federal Energy Regulatory Commission, staff report on the implementation of Section 208 of the Public Utility Regulatory Policies Act of 1978 320
  Letter to the attorney general, State of Rhode Island 555
Edwin Rothschild, Energy Action Project, Washington, D.C 339
  Prepared statement 339
  Ronald Carr, Deputy Assistant Attorney General of the Antitrust Division, speech before the American Gas Association, March 31, 1982 350
Panel discussion:
  Interstate pipeline company acquisitions 346
  Impact on customer costs 347
  Risks of investment in utilities 348

TUESDAY, JUNE 8, 1982

Page

Opening statement of Senator D'Amato 355

WITNESSES

- John S. R. Shad, Chairman, Securities and Exchange Commission, accompanied by Bevis Longstreth, member, SEC 356
  - Reasons for repeal of the Act 356
  - Deterioration of financial condition 357
  - Prepared statement 359
    - Introduction 359
    - History and structure of the 1935 Act 363
    - Commission administration of the Act 379
    - The Commission's recommendation 387
    - The 1935 Act and diversification 410
    - Conclusion 421
    - Appendix A—Outline of major provisions of pending bills to amend the Public Utility Holding Company Act of 1935 422
    - Appendix B—Section by section analysis 425
    - Appendix C—Statement of Aaron Levy, Director, Division of Corporate Regulation, SEC, presented to House Committee on Energy and Commerce, June 9, 1982 444
  - Act has served its purpose 483
  - SEC areas of responsibility 484
- William F. Baxter, Assistant Attorney General, Antitrust Division, Department of Justice 486
  - Possible abuses of diversification 486
  - Functional diversification 487
  - Prepared statement 488
  - Limits on utility diversifications 496
- Richard E. Schuler, deputy chairman, New York Public Service Commission, Albany, N.Y., on behalf of the National Association of Regulatory Utility Commissioners 498
  - Design a flexible policy on diversification 498
  - Powers of State commissioners 499
  - Interstate conflicts 501
  - Prepared statement 502
    - Regulatory devices currently available to State Commission 503
    - Augmentation of State Commission authority 503
    - Remaining regulatory problems if act is repealed 504
    - Conclusions 504

Panel discussion:

- Consumer and investor protection 505
- Repeal of act necessary 506

- Vince Stanley, V. J. Stanley, Inc., Rochester, N.Y., on behalf of the American Supply Association 507
  - Repeal would further exacerbate serious situation 507
  - Monopoly guaranteed rate of return 509
  - Enviable market position 509
  - Prepared statement 512
    - Competition 514
    - Utilities in heating, cooling and energy conservation 519
- Dennis Lavallee, director of government affairs, National Association of Plumbing, Heating & Cooling Contractors 520
  - Revisions threaten small businesses 520
  - Areas of jeopardy 521
  - Prepared statement 522
    - PUHCA discourages monopolization and encourages competition 523
    - Removal of restrictions would encourage circumvention of other laws 523
    - Removal of restrictions would promote unfair anticompetitive behavior 523
    - Market disruption has already begun 524
    - Conclusion 525
    - Cases of unfair utility competition 525
    - Cases of fair competition 525
- Tom Lewis, State senator, Albuquerque, N. Mex 529

Page

- Tom Lewis, State senator, Albuquerque, N. Mex—Continued
  - Impact of utility diversification ... 530
  - Regulatory problems ... 532
  - Prepared statement ... 533
  - Moratorium on diversification ... 536
  - Investing in nonutility operations ... 538
  - Examples of competition ... 540
  - Decision of amendment or repeal ... 542
  - Benefits exaggerated ... 544

THURSDAY, JUNE 10, 1982

- Opening remarks by Senator D'Amato ... 547

WITNESSES

- Dennis Roberts, attorney general, State of Rhode Island ... 547
  - Repeal could be extremely disruptive ... 548
  - Charging ratepayers for investment failures ... 549
  - Prepared statement ... 551
    - Letter from the law firm of Spiegel and McDiarmid narrating a series of instances in which the act has benefited the consumer ... 555
  - Essential features of the Act ... 566
- G. J. Tankersley, chairman and chief executive officer, Consolidated Natural Gas Co., Pittsburgh, accompanied by Richard Dunham, former Chairman, Federal Power Commission ... 568
  - Prepared statement ... 569
  - Relief from archaic restrictions ... 593
  - Study highlights ... 594
  - Testimony of C. Luther Heckman, attorney and partner in the firm of Porter, Wright, Morris & Arthur ... 682
  - Prepared statement of Richard L. Dunham, president of H. Zinder & Associates ... 690
- Guy W. Nichols, chairman, New England Electric Systems, Westborough, Mass ... 596
  - Protecting investor interest ... 596
  - Judicial opinion supports regulators ... 598
  - Prepared statement ... 600
- William H. Grigg, executive vice president, Finance and Administration, Duke Power Co., Charlotte, N.C ... 640
  - Industry searching to improve financial conditions ... 641
  - Allocation of Costs ... 642
  - State approval necessary ... 644
  - Prepared statement ... 646
- Panel discussion:
  - Effect of changes in act ... 675
  - Significant benefits to management ... 676
- John G. L. Cabot, senior vice president, Cabot Corp., Boston, Mass ... 707
  - Prepared statement ... 708
    - Background on Cabot ... 708
    - Chart 1—Net sales vs. utility sales ... 713
    - Chart 2—Average price for households ... 714
    - Chart 3—Sales restriction periods ... 715
    - Financial practices and information disclosure ... 716
    - Accounting practices ... 717
  - Historic accident ... 719
  - Operate utilities as subsidiaries ... 721
- John W. Barr, principal, Morgan Stanley, Inc., New York ... 722
  - Major reasons for repeal of act ... 722
  - Financial strength is a misnomer ... 724
  - Prepared statement ... 726
    - Diversification ... 727
    - Financial flexibility ... 730
- Richard Rosenthal, chairman, Citizens Utilities Co., Stamford, Conn ... 732
  - States expanding powers ... 732
  - Comments on Solomon Brothers report ... 734
  - Channeling profits to shareholders ... 734

ADDITIONAL MATERIAL RECEIVED FOR THE RECORD

Page
Environmental Action Foundation, statement received for the record ... 736
Centel Corp., statement received from Karl Berolzheimer, vice president and general counsel ... 744
Statement from American Iron and Steel Institute ... 750
Statement of the Electricity Consumers Resource Council ... 758

PUBLIC UTILITY HOLDING COMPANY ACT AMENDMENTS

TUESDAY, APRIL 27, 1982

U.S. Senate,
Committee on Banking, Housing and Urban Affairs,
Subcommittee on Securities,
Washington, D.C.

The subcommittee met at 9:30 a.m. in room 5302, Dirksen Senate Office Building, Senator Alfonse D'Amato (chairman of the subcommittee) presiding.

Present: Senators D'Amato and Brady.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'Amato. The subcommittee will come to order.

This morning the Subcommittee on Securities begins a comprehensive review of the Public Utility Holding Company Act. Pending before the subcommittee are several proposals to amend or repeal the act: S. 1869, S. 1870, S. 1871 which Senator Johnston joined me in introducing last November, and S. 1977 which Senator Johnston introduced last December. These proposals raise many important questions affecting the utility industry, ratepayers, and investors.

I commend my colleague, Senator Johnston, for his support in bringing these matters to the attention of the Senate. I'm also gratified to see that Congressman Corcoran and Congressman Tauzin have directed their efforts toward promoting full consideration of these issues in the House.

The Public Utilities Holding Company Act is the least widely known of the Federal securities laws administered by the SEC. Enacted in 1935, the statute was intended to eliminate a range of abusive practices in which the huge and powerful utility holding companies of the 1920's had engaged. These practices, which operated to the detriment of investors and utility ratepayers alike were found to be outside the reach of effective State regulation. The 1935 act authorized the SEC to require utility holding company systems to adopt integrated simplified structures and to prevent the recurrence of abusive practices through the regulation of utility financing, acquisitions and dispositions of assets, and service and other contracts with potential conflicts of interest.

Many in the utility industry have argued that the 1935 act has accomplished its purposes and now serves only as an additional regulatory burden on an already financially distressed industry. While I expect that this view will be disputed in some quarters—

indeed, in many quarters—even a cursory review of the statute indicates that the regulatory presence of the SEC in this area is extraordinarily broad and intrusive.

During these hearings, the subcommittee intends to closely examine both the need for Federal intervention in the operation of utility holding companies and the form which it has taken.

We begin these hearings today with a number of distinguished witnesses. I'm particularly pleased to welcome Senator Johnston as our first witness.

STATEMENT OF BENNETT J. JOHNSTON, U.S. SENATOR FROM THE STATE OF LOUISIANA

Senator Johnston. Thank you very much, Mr. Chairman.

Mr. Chairman, as you pointed out, you and I and others have introduced several bills to change the Public Utilities Holding Company Act or PUHCA, I guess they call it. We put in three bills to change parts of the act which were particularly counterproductive and in the process of working on those three bills it became apparent to me, to you, and indeed to the Securities and Exchange Commission, that PUHCA itself should be repealed, that there was no reason to keep this obsolescent law on the books, because it had, as you well pointed out in your opening statement accomplished that which it was designed to accomplish back in 1935. It did dismantle the holding companies that were in operation at that time and at the same time the Securities and Exchange Commission superstructure which was created just about contemporaneously with the passage of PUHCA has become more than sufficiently effective to regulate the very same concerns that were the object of the passage of PUHCA in the first place.

Why should we repeal PUHCA now if indeed it has been on the books all these years and companies have been operating within the constraints of PUHCA?

Well, the reason is, as you also point out, that public utilities are in particularly bad shape economically at the present time. Price-earnings ratios, or equity-earnings ratios have never been as low for the utility industry as they are now. Debt ratings of their securities are down exceedingly low. Their stocks are down. With Three Mile Island, with the increased cost of fuel, with increased cost of construction, it is an economically difficult thing to be in the public utility business today.

And any additional constraints, particularly the kind of redundant restraints that PUHCA puts on utilities should be repealed. For example, when a company or public utility company wants to go to the bond market it must get its issues cleared for a period of 60 days under the provisions of PUHCA before it can go to the market. Well, with today's highly volatile markets, 60 days is usually enough time for the market picture to change, for rates to be different from when they made their application, and consequently, many debt issues under that one provision are prevented from going to the market.

So, Mr. Chairman, I think it is perfectly clear that the reasons for PUHCA—that is, customer ratepayer protection and investor protection—have been accomplished at least 20 years ago, that there is more than sufficient protection under the present law, under the Federal Power Act, under the Securities Acts of 1933 and 1934, and under State authorities to take care of the very goals that PUHCA was designed to accomplish, and it is perfectly clear, Mr. Chairman, that to repeal PUHCA would be in the public interest.

Mr. Chairman, after introducing S. 1977, we received a letter from the Securities and Exchange Commission and I think one paragraph summarizes it very well. It's a three-page letter addressed to you and if it is not in the record I'd like to offer it in the record at this time if I may.

Senator D'AMATO. So ordered.

[Letter follows:]

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., December 21, 1981.

Re Prosposals to amend the Public Utility Holding Company Act of 1935 (S. 1869, S. 1870, and S. 1871).

Hon. ALFONSE M. D'AMATO,
Chairman, Subcommittee on Securities, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C.

DEAR CHAIRMAN D'AMATO: In response to a request from your staff, I am writing to advise you of the Commission's general views relating to the above three bills. These bills would substantially reduce regulation under the Public Utility Holding Company Act of 1935. The Commission, however, unanimously believes that Congress should instead repeal the Act. Based on the information available to the Commission and its experience under the Act, we believe that this statute has served its basic purpose and that continued federal regulation of utility holding companies is unnecessary and inappropriate.

The Securities and Exchange Commission has administered the 1935 Act for nearly forty-seven years. There is a consensus—shared by the Commission—that the Commission's task of reorganizing the Nation's gas and electric utility holding company systems was completed twenty years ago. The Commission's administration of the Act in more recent years has primarily involved review of registered holding company financings, mergers, and acquisitions and the consideration of requests for exemptions from the Act. These remaining Commission responsibilities are intended to prevent recurrence of the abuses which led to the original passage of the Act. The Commission believes, however, that these abuses are unlikely to recur in light of the extensive changes since 1935 in the public utility and invesment banking industries, the accounting profession, state utility regulation, expansion of the disclosure requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934, and the development of more efficient and well-informed securities markets. If the 1935 Act is repealed, all publicly-owned utility holding company systems will, of course continue to be subject to the financial disclosure requirements and other provisions of the federal securities laws.

Moreover, certain features of the 1935 Act set it apart from the other statutes which the Commission administers. The federal securities laws focus primarily on disclosures to investors and on the integrity of the securities markets. In contrast, acquisitions, financings, and other actions by registered public utility holding company systems require prior Commission approval under the 1935 Act. The Commission must base its approval or disapproval of these transactions on its determination of their economic merits. Thus, unlike the other statutes it administers, the 1935 Act involves the Commission very deeply in the substance of fundamental management decisions.

Only twelve active holding company systems remain subject to direct regulation under the 1935 Act. The Act, however, continues to have significant influence on the financing and diversification decisions of a much larger portion of the industry. Approximately eighty holding company systems operate under various exemptions from the Act, and many utilities may be reluctant to form holding companies because they would then have to register under the Act or qualify for an exemption. Furthermore, in this time of energy shortages and the recognized need to develop new energy resources, the Act may deter non-utilities from participating in cogeneration projects or other such activities because of the consequences of becoming subject to the Act.

The Commission finds it difficult to support any of the three legislative proposals presently before Congress because each primarily addresses only those aspects of the Act that affect one segment of the industry. Each would have the practical effect of virtually repealing the Act as it affects that particular industry segment. Taken together, the three proposals approach total repeal and would leave the Commission with responsibility for administering only the very limited surviving provisions of the Act with no clear regulatory purpose. None of the three proposals takes the further step of addressing the basic rationale for continued regulation under the Act.

For these reasons, it is appropriate and timely for Congress to revisit the 1935 Act. Congress should not, however, limit its evaluation to the merits of these specific proposals, but should also reexamine the underlying premises of the Act to determine the extent to which those premises have continuing viability today.

Because of the importance I attach to eliminating unnecessary regulatory burdens, I wanted to inform you promptly of the Commission's general position on the pending bills. The Commission will submit a detailed, formal statement of views at an appropriate time. In the interim, if members of your staff would like additional information, they should contact our General Counsel, Edward F. Greene, or Elinor Gammon in the Office of the General Counsel.

Sincerely yours,

JOHN S. R. SHAD.

Senator JOHNSTON. And the one paragraph of course totally summarizes it when they say—after talking about the three bills I've previously discussed—it says as follows:

> The Commission, however, unanimously believes that Congress should instead repeal the act. Based on the information available to the Commission and its experience under the act, we believe that this statute has served its basic purpose and that continued federal regulation of utility holding companies is unnecessary and inappropriate.

A unanimous judgment of the Securities and Exchange Commission whose job it is to protect the consumer, to protect the investor, and, Mr. Chairman, I think the case is overwhelming and I hope this committee will act with the dispatch that the chairman is noted for.

[The complete statement follows:]

STATEMENT OF SENATOR JOHNSTON

Senator JOHNSTON. Mr. Chairman and members of the committee, thank you for the opportunity to appear before you today to testify on behalf of S. 1977, a bill to repeal the Public Utility Holding Company Act of 1935.

I am sure that all of you are aware of the current financial distress being experienced by our Nation's electric utility industry. The utility bond market, once a haven for secure investment, has undergone a severe financial decline, placing debt ratings at all time low levels. The market prices for common stocks of electric utilities have fallen dramatically since 1977, with many utility stocks now priced far below book values. High construction and fuel costs coupled with high interest rates suggest that this situation may not change for some time.

In an effort to help alleviate these financial woes I introduced S. 1977 to eliminate the excessive and counterproductive Federal regulation inherent in the Public Utility Holding Company Act of 1935 (PUHCA).

PUHCA was passed during the New Deal in an effort to remedy the abusive manner in which public utilities were conducting and financing their operations. The primary evil sought to be eradicated was the pyramidal structure of the massive public utility holding companies. Because those companies owned subsidiaries randomly throughout the United States, they were able to avoid the somewhat feeble attempts of individual States to regulate them. In an effort to combat these abuses, Congress passed PUHCA, conferring upon the Securities and Exchange Commission (SEC) extensive authority over public utility holding companies.

The PUHCA subjected the holding companies to essentially two types of regulation. The first required that utility holding companies undergo a simplification of their corporate and capital structures, and that they become geographically integrated. To this end, Congress directed the SEC to undertake capital reorganizations of public utility holding companies in order to ensure that "the holding company system does not unduly or unnecessarily complicate the structure, or unfairly distribute voting power among security holders" (PUHCA § 11(b)(2)). Further Congress authorized the SEC to reorganize public utility holding company systems into single integrated utility systems operating in contiguous geographic areas, thus rendering them more susceptible to State and local regulation.

Simply put, the SEC was empowered to break up the enormous pyramidal structures, a goal which was accomplished by 1950. In order to prevent these holding companies from again spreading into non-contiguous geographic areas, Congress provided that public utility holding company systems obtain SEC approval prior to acquiring other public utility systems.

The second objective of the act was to subject the essential financial decisions of public utility holding companies and their subsidiaries to SEC review. In many instances, companies subject to the act must obtain prior SEC approval for basic financing activities, including securities issuances, assumptions of liability, and investment decisions in non-utility subsidiaries. The PUHCA gives the SEC power to refuse to approve a transaction whenever it would tend toward producing interlocking relations or a concentration of control, would unduly complicate the capital structure of the holding company, or when it involves the payment of fees considered by the Commission to be unreasonable. The SEC can effectively veto a utility's decision to diversify or to enter into service contracts even though a State regulatory commission may have already approved the transaction.

Congress armed the SEC with these extraordinary powers because of a perceived inadequacy in the workings of the newly enacted Securities Act of 1933 and the Securities Exchange Act of 1934. These perceptions led Congress to rely not merely on disclosure, but on unprecedented governmental supervision over a utility's operations.

As we all know, however, the Securities Act of 1933 and 1934 turned out to be far more effective than anticipated. The disclosure and reporting requirements of these acts apply with equinimity to the sale of securities by a public utility, thus duplicating many of the reporting and disclosure requirements of the PUHCA.

In addition, separate regulatory authorities provide the basis for regulation and control of certain transactions and investments by public utilities. For example, the Federal Energy Regulatory Commission, in exercising its wholesale ratemaking power, monitors transactions among affiliates to insure they are just and reasonable (see, e.g. Docket No. RM 79-41; study of the transfer price of coal sold to utilities by their subsidiaries) section 204(a) of the Federal Power Act authorizes the Federal Energy Regulatory Commission to approve the issuance of securities by a public utility, or the assumption of liability with respect to the securities of another public utility unless the utility is organized and operated in a state which regulates its securities issuances. Indeed, some 45 States now require approval of a State commission prior to the issuance of securities by a public utility.

Clearly the potential for such effective State regulation is now much greater than in 1935. State regulatory bodies are more aggressive. Standardization of accounting practices and experience with regulatory programs indicate that States are no longer inadequately equipped to regulate the financial activities of utilities.

The upstart of all this is that regulation of public utility holding companies under the PUHCA is duplicative and unnecessary. The enormous holding company structures of the past have long since been broken up. Disclosure requirements for public utilities are regulated by the 1933 and 1934 Securities Acts. Securities issuances and affiliate transactions are regulated by the Federal Power Act, and States have achieved the level of sophistication necessary for effective regulation of remaining managerial decisions with broad consumer impacts.

As a further indication of the act's obsolescence, I would note that it now applies to only 12 companies nationwide. All other companies have long been exempted based on a SEC finding that the holding companies and their subsidiaries carry on their business in a single State or in immediately contiguous States.

Yet, the act remains on the books, forcing those 12 remaining companies to subject the planning and the substance of their investment and financing decisions to the rigors of prior SEC review. Unnecessary regulation under PUHCA severely constrains the scope of management discretion by prohibiting some investment opportunities outright, while effectively precluding certain financing options which cannot await the conclusion of SEC review procedures.

The financial condition of the electric utility industry has deteriorated to the point that affirmative steps must be taken to assist it. One such step would be the elimination of the unnecessary and unproductive regulatory requirements of the PUHCA. A holding company is no longer the uncontrolled leviathon it was in the 1920's. It is a straight-forward and effective business management device which, through diversification, can spread financial risks, increase economic benefits, and improve the over all performance of the electric utility industry.

But the existence of the Public Utility Holding Company Act serves to constrain and prevent such activities. I strongly suggest that it be repealed and I urge your favorable consideration on S. 1977.

Senator D'AMATO. Well, I thank my distinguished colleague from Louisiana not only for his incisive testimony, but more particularly for his guidance and work on the proposals before us. I think it's noteworthy that, as you've indicated, the SEC itself has supported repeal, and unanimously at that. Who would have ever thought that the Securities and Exchange Commission would call for the repeal of legislation which takes away some of its authority. I think that's interesting, that that should be noted. No one even abstained. [Laughter.]

I was wondering if anyone would pick that up. It's worthy of some note and I look forward to a markup on the bill and hopefully we can get some decisive action, something that we haven't been able to get on too many pieces of legislation during this session to date.

I want to thank the distinguished Senator from Louisiana.

I'd like to recognize my distinguished colleague from New Jersey, Senator Brady, who I think might like to make a statement for the record.

Senator **BRADY**. Thank you, Senator D'Amato. I really don't have a statement for the record. I'm interested in the testimony here this morning and support the general thrust of the remarks that you've made so far.

Senator **D'AMATO**. Thank you very much.

We have with us Congressman Tom Corcoran from the House of Representatives. Is Congressman Tauzin here? Why don't you both come forward.

STATEMENT OF TOM CORCORAN, REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Representative **CORCORAN**. Thank you very much, Senator, and, Mr. Chairman, I want to first of all express my appreciation for your interest in this subject, the interest of Senator Johnston and of course others of your colleagues here in the Senate, and I particularly appreciate the fact that you're holding hearings. I think that to some extent that has helped us secure hearings in the House as well.

My own interest in this matter develops from two or three perspectives. First of all, I've been concerned for some time about the financial condition of the utilities and, in that respect, I've noticed with some alarm that over the last several years there's been what I would regard as a creeping nationalization in the utility industry. For instance, in your own State of New York, in the State of North Carolina, and also of course in the Northwest, that more and more we see private utility companies selling either their generating stock or some other of their assets to public entities. Con Edison did that, of course, as you know, in New York. Duke Power did it in North Carolina and the same I think is happening with Bonneville Power Administration in the Northwest.

And I don't know whether that's a good thing or not, Mr. Chairman, but I do think that we ought to consciously as a country and as policymakers address that question and decide whether or not we want to see the demise of the investor-owned utility system that we have regulated primarily at the State level by the public utility commission and instead develop some kind of a Federal power authority or a municipal power authority in order to own and make decisions about new plant construction, the replacement of existing plant capacity and the like.

And it's within that context that I think the fact that you're holding hearings, the fact that you and your colleague, Senator Johnston and Congressman Tauzin and myself and others in the House, are appropriately addressing the question of whether or not there may be some existing statutory roadblocks that ought to be examined. And I, for one, believe that the Public Utility Holding Company Act happens to be one of those existing statutes that, as Senator Johnston pointed out, is perhaps obsolete at this point. My own legislation addresses a reform of the act but I think, as Senator Johnston and Congressman Tauzin have indicated, we ought to seriously consider the question of outright repeal as well.

So I think it's most appropriate that the Congress in both Houses is now examining this question and there will be hearings and we can make our decisions accordingly.

I would like to submit a statement for the record, Mr. Chairman, and also at this point highlight a couple of the points that I have made in my statement.

Senator D'AMATO. So ordered.

STATEMENT OF CONGRESSMAN CORCORAN

Representative CORCORAN. Mr. Chairman, I commend you for scheduling these legislative hearings on this important issue. As a member of the House Energy and Commerce Committee which has jurisdiction over the Public Utility Holding Company Act, and as the first Member of the House to introduce legislation relating to the Holding Company Act during this Congress, I very much appreciate the opportunity to testify here today.

FINANCIAL CONDITION OF THE UTILITY INDUSTRY

This country's utilities are experiencing serious financial difficulties, which, if allowed to continue, could have a devastating impact on the Nation's economy. By almost any financial measure, the industry is in trouble.

The common stocks of most utilities were selling at approximately 85 percent of their book values earlier this month. As recently as the 1960's the industry average was 250 percent of book value. This dramatic deterioration was cited by the Committee on Energy of the Aspen Institute in its publication, "Utilities in Crisis: A Problem in Governance." The Committee offered the following as a partial explanation: "Dividends to stockholders, which were formerly a major attraction for [utility] investors, have declined * * * in real terms. The average yield * * * when adjusted for stock price declines, is well below the average total investor returns from industrial stocks or other competitive investments." Recently, the financial condition of many utilities was so bad that they were paying common stock dividends that actually exceeded cash earnings.

If one looks at the debt portion of total capitalization, the picture is equally disturbing. In 1970, for example, only 4 percent of electric utility bonds had a BBB rating, the lowest of "investment grade security ratings." In 1981, 30 percent were so rated. In November 1981, 74 percent of all electric utilities had bond ratings lower than AA compared to only 40 percent 10 years earlier. This downward trend has been accelerating in recent years. In 1980, for example, 28 utilities had their bond ratings lowered while only three had them upgraded. Naturally, lowered bond ratings result in higher interest charges that are ultimately billed to ratepayers.

This dramatic deterioration in utility financial performance at times when other industries experienced record earnings has caused investors to flee the utility industry making it even more difficult for utilities to raise capital on reasonable terms. According to a detailed economic study conducted by the Cabot Consulting Group, a copy of which I submitted to this subcommittee with my April 5 request to testify here today, "Traditional buyers of utility securities have been confronted with a proliferation of relatively more attractive investment alternatives * * * all providing better yields with lower risk than most utility securities. Therefore, investors have turned away from the utility industry to find more attractive investments elsewhere. Diversification, a business option and normal practice in most industries, can selectively help increase earnings or decrease risk and may improve the attractiveness of both electric and gas utility securities as a result." Such diversification would facilitate the raising of capital for the utility and thus reduce costs to the ratepayer.

SURVEY OF UTILITIES AND STATE COMMISSIONS PRIOR TO INTRODUCTION OF H.R. 5220

In October of last year, I sent a questionnaire regarding the Holding Company Act to approximately 150 utility executives and each of the 50 State Public Service Commissions. Based, in part, on the results of these questionnaires, on December 15 of last year, I introduced the Public Utility Financial Reform Act (H.R. 5220). My Congressional Record statement accompanying the introduction of this legislation is attached hereto.[1] With your permission, Mr. Chairman, I would like the responses to such questionnaires to be included in the hearing record.[2] This bill would amend section 3 of the Holding Company Act to facilitate the formation of and diversification by exempt electric and gas utility holding companies. It also provided that diversified activities of a utility holding company should be undertaken through the use of a separate corporate subsidiary which would prevent "cross-subsidization" between the utility and non-utility businesses.

ADMINISTRATION AND HOUSE ACTIVITIES RELATING TO THE HOLDING COMPANY ACT

Less than a week after I introduced my bill, the Securities and Exchange Commission unanimously recommended repeal of the Holding Company Act. In support of this position, Chairman Shad of the SEC noted that the abuses the Holding Company Act was designed to correct "are unlikely to recur in light of the extensive changes since 1935 in the public utility and investment banking industries, the accounting profession, state utility regulation, expansion of the disclosure requirements under the Securities Act of

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[1] See Congressional Record, Dec. 15, 1981, p. H9697.
[2] See p. 13.

1933 and the Securities Exchange Act of 1934, and the development of more efficient and well-informed securities markets." Chairman Shad concluded in effect by saying that the Holding Company Act no longer serves any useful purpose. As an illustration of that point, it is worth noting that in 1945 there were approximately 250 people at the SEC administering the Holding Company Act. Today, there are fewer than 20.

Mr. Chairman, I understand that the administration is in the process of formulating their position with respect to the Holding Company Act, and I hope that they will avail themselves of any opportunity to testify before this Subcommittee on this very important issue. Also, I would like at this point to submit for the record the recent correspondence that I have had with DOE, FERC and the SEC with respect to the Holding Company Act.

Mr. Chairman, Dick Ottinger, Chairman of the Energy Conservation and Power Subcommittee of the House Energy and Commerce Committee, advised me when we met late last week that he intended to hold legislative hearings on the Holding Company Act in late May or early June. I would like to commend him for taking such action. Previously, Chairman Ottinger had indicated he thought the Holding Company Act may be a "barrier to innovative utility management." It seems to me that diversification into non-utility businesses is a good example of inovative utility management and, as a result, even if the Holding Company Act were not repealed as the SEC suggests, I think that at the least it should be amended in order to facilitate diversification.

DIVERSIFICATION

One of the important questions relating to utility diversification concerns the types of businesses into which utilities are likely to diversify. Several business activities have been generally identified in various surveys as presenting opportunities that may merit consideration by certain utilities. Among these are various alternative energy sources such as solar power, wind-generation and refuse-derived fuel; coal and other mineral and resource development; petroleum exploration, development and production; computer services, especially those relating to load management or other conservation techniques; and industrial real estate development, primarily of properties presently held by utilities but no longer useful in the utility business.

Diversification into these areas could be undertaken by utilities in joint ventures with industrials, through the creation of a new business or the acquisition of an existing one or, simply, as a passive investor. In any event, the likely areas of diversification are those that are energy related, and would further the development of our Nation's energy resources, in addition to improving the financial performance of the utility industry.

Mr. Chairman, my primary interest in reforming the Holding Company Act relates to diversification as a means of improving the utility industry's financial performance. In this regard, I understand that the National Association of Regulatory Utility Commissioners (NARUC) plans to offer testimony before this subcommittee and has recently circulated a draft report on utility diversification that refers to the Holding Company Act. I was disappointed to note that while the NARUC draft report considered the possible effects of diversification on their own administrative burden, they ignored the most important national issue—the impact that the industry's current serious financial and economic condition may have on our Nation's energy resources. And while NARUC properly expressed the need to safeguard the interests of ratepayers, they should also have recognized their obligation to protect investors; for without continued investments, the utility industry will be unable to provide reliable service to our citizens and businesses in the future.

As I have mentioned, in October I sent questionnaires to the chairman of every State Public Service Commission asking them whether they favored repeal of the Holding Company Act or modification of section 3. Twenty-one State Public Service Commissions responded to that survey. Although some of those responses parallel the draft NARUC report, other State Public Service Commissions indicated that they favored repeal of the Holding Company Act, and even more suggested that it should be amended to facilitate diversification. For example, one State Public Service Commission responded as follows:

> Concerning your amendment [H.R. 5220] to Section 3 of the Public Utility Holding Company Act; it must be recognized that some type of realistic financial relief is needed for the nation's utilities, and at the same time keeping in mind their ability and flexibility in providing viable energy resources. It is evident that you address this exact situation with the concern of investors and consumers (ratepayers) in mind. Your amendment, as I read it, adequately protects against cross-subsidization between the utility business and non-utility business, when entering into diversification.

It must be recognized, however, that although diversification may improve the financial performance of the industry, important utility rate issues still remain to be resolved. As long as utility returns are kept below the level required to stem the flow of capital from the utility industry, the ability of utilities to adequately serve their customers will continue to be threatened regardless of whether utilities are allowed to diversify. Diversification is not a panacea nor the sole solution to the contemporary financial problems of the industry or its ratepayers. But, in an economy where regulated utilities must compete in the capital markets with unregulated industries and the Federal government for limited amounts of capital, diversification represents one innovative management technique that could be used by the industry to facilitate capital formation and, thus, its long-term survival.

Mr. Chairman, I would like to thank you for the opportunity to testify before this distinguished subcommittee. I would applaud an affirmative vote by its members in support of repeal of the Holding Company Act or, at the very least, I would encourage support of S.1870, a similar piece of legislation to H.R. 5220, The Public Utility Financial Reform Act.

Thank you, Mr. Chairman, this concludes my prepared remarks.

Representative CORCORAN. Mr. Chairman, this country's utilities are experiencing serious financial difficulties which, if allowed to continue, could have a devastating impact on the Nation's economy. By almost any financial measure, the industry is in trouble.

And I would refer you to the Committee on Energy of the Aspen Institute in its publication, "Utilities in Crisis: A Problem in Governance," as but one recent evaluation of the financial condition of the utilities as a whole across our country to suggest that we in the Congress need to examine the question and see what might be done.

INVESTORS FLEE UTILITY INDUSTRY

This dramatic deterioration in utility financial performance at times when other industries experience record earnings has caused investors to flee the utility industry, making it even more difficult for utilities to raise capital on reasonable terms.

According to a detailed economic study conducted by the Cabot Consulting Group, a copy of which I submitted to this subcommittee with my April 5 request to testify here, I quote:

> Traditional buyers of utilities securities have been confronted with a proliferation of relatively more attractive investment alternatives, all providing better yields with lower risks that most utility securities. Therefore, investors have turned away from the utility industry to find more attractive investments elsewhere.
>
> Diversification, a business option and normal practice in most industries, can selectively help increase earnings or decrease risk and may improve the attractiveness of both electric and gas utility securities as a result.

Mr. Chairman, in October of last year, I sent a questionnaire regarding the Holding Company Act to approximately 150 utility executives and each of the 50 State Public Service Commissions. Based, in part, on the response to that questionnaire, on December 15 of last year I introduced the Public Utility Financial Reform Act, H.R. 5220. My Congressional Record statement accompanying the introduction of this legislation is attached hereto. With your permission, I would like to have the responses to that questionnaire made a part of the record of this subcommittee's hearings.

Senator D'AMATO. So ordered.

[The material received for the record follows:]

RESPONDENTS TO CONGRESSMAN CORCORAN'S OCTOBER 27, 1981, LETTER/QUESTIONNAIRE
REGARDING THE PUBLIC UTILITY HOLDING COMPANY ACT.
LETTERS LISTED CHRONOLOGICALLY IN ORDER OF RECEIPT.

	UTILITIES	STATE
1.	Allegheny Power System, Inc.	NY
2.	Public Service Company of Oklahoma (2 responses)	OK
3.	Kansas City Power & Light Company	MO
4.	Commonwealth Edison	IL
5.	Virginia Electric and Power Company (2 responses)	VA
6.	Bangor Hydro-Electric Company	ME
7.	Montana-Dakota Utilities Company	ND
8.	Northeast Utilities	CT
9.	Minnesota Power	MN
10.	Duquesne Light Company	PA
11.	Mississippi Power & Light Company	MS
12.	Iowa Resources Inc.	IA
13.	Illinois Power Company	IL
14.	Peoples Energy Corporation	IL
15.	Cosolidated Edison Company of New York	NY
16.	Wisconsin Electric Power Company	WI
17.	Consolidated Natural Gas Company	PA
18.	Eastern Gas and Fuel Associates	MA
19.	Consumers Power Company	MI
20.	Public Service Electric and Gas Company	NJ
21.	Montana Power Company	MT
22.	NICOR	IL
23.	Duke Power Company	NC
24.	Atlantic Electric	NJ
25.	Columbia Gas System	DE
26.	Potomac Electric Power Company	DC
27.	Intermountain Gas Company	ID
28.	Pacific Gas and Electric Company (2 responses)	CA
29.	The Washington Water Power Company	WA
30.	Middle South Utilities, Inc. (2 responses)	LA
31.	General Public Utilities Corporation	NJ
	Received after Nov. 30, 1981	
32.	National Fuel Gas Company	NY
33.	Carolina Power & Light Company	NC
34.	Baltimore Gas and Electric	MD
35.	New England Electric	MA
36.	American Electric Power Company	OH
37.	Houston Industries Incorporated	TX
38.	Central Illinois Light Company	IL
39.	Hawaiian Electric Company	HI
40.	Puget Sound Power & Light Company	WA
41.	Eastern Utilities Associates	MA
42.	Public Service Indiana	IN
43.	Texas Utilities Company	TX
44.	Central and South West Corporation	TX
45.	Ohio Edison Company	OH
46.	Central Illinois Public Service Company	IL
47.	Wisconsin Power & Light Company	WI

	UTILITIES (continued)	STATE
	Received after December 15, 1981	
48.	Northern States Power Company	MN
49.	Washington Gas	DC
50.	Wisconsin Power & Light Company	WI
51.	Bay State Gas Company	MA
52.	Kansas City Power & Light Company	MO
53.	Teco Energy INC.	FL
54.	Mississippi Power & Light Company	MS
55.	South Carolina Electric & Gas Company	SC
56.	Northern Indiana Public Service Company	IN
57.	Public Service Indiana	IN

PUBLIC UTILITY COMMISSIONS

1. Wyoming
2. Hawaii
3. Colorado
4. Idaho
5. Wisconsin
6. Oregon
7. Maryland
8. Virginia

Received after Nov. 30, 1981

9. Kansas
10. Delaware
11. Texas
12. Indiana
13. Georgia
14. Illinois
15. Connecticut

Received after December 15, 1981

16. Iowa
17. Nevada
18. Rhode Island
19. Washington
20. Florida (2 responses)

MISCELLANEOUS AND ADDENDUM (FOR RESPONSES RECEIVED FEBRUARY 1, 1982 AND AFTER)

Cabot Corporation
58. CP National CA
21. Arkansas
Morgan, Lewis & Bockius

TOM CORCORAN
15th District, Illinois

ENERGY AND COMMERCE
COMMITTEE

SUBCOMMITTEE ON ENERGY
CONSERVATION AND POWER

SUBCOMMITTEE ON FOSSIL AND
SYNTHETIC FUELS

POST OFFICE AND CIVIL
SERVICE COMMITTEE

SUBCOMMITTEE ON HUMAN RESOURCES

SUBCOMMITTEE ON POSTAL OPERATIONS
AND SERVICES

Congreſs of the United States
House of Representatives
Washington, D.C. 20515

Washington Office:
1107 Longworth House Office Building
Washington, D.C. 20515
[illegible]

Illinois Offices:
[illegible] North Lake Street
Aurora, Illinois [illegible]
(312) [illegible]

[illegible] West Lafayette Street
Ottawa, Illinois [illegible]
[illegible]

Illinois Toll-Free Action Line
[illegible]

October 27, 1981

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Two Legislative Approaches:

APPROACH ONE: Repeal the PUHCA with provisions stating that such repeal would not affect any PUHCA proceedings previously commenced.

Question 1: To what extent, if any, do utility companies continue to present the problems of size and structural complexity the Act was intended to correct? Please specify.

Question 2: To what extent would federal and state law adequately protect the interests of stockholders and ratepayers were PUHCA to be repealed?

Question 3: Would the repeal of PUHCA result in conflicting state regulation? To what extent, if any, would this affect the public interest?

Question 4: Does the public have enough confidence in their state PUCs to reduce the federal role in regulation of local utilities?

Question 5: In your opinion, how would repeal affect your state PUC, the utilities, stockholders, and ratepayers? In particular, to what extent, if any, would repeal of PUHCA lead to diversification?

APPROACH TWO: Amend Section 3 of PUHCA, first, to exempt holding companies with only one public utility subsidiary, provided such subsidiary's operations are limited to its state of incorporation and contiguous states; second, to exempt holding companies created by companies that are presently exempt under Section 3(a)(2) of the Act; and, third, to remove the "unless and except" clause.

Question 1: To what extent, if any, would this approach lead to utility diversification?

Question 2: In your opinion, how would enactment affect your state PUC, the utilities, stockholders, and ratepayers? In particular, to what extent, if any, would enactment lead to diversification?

RESPONSES FROM UTILITY COMPANIES

CPnational

BEN W. AGEE
PRESIDENT AND
CHAIRMAN OF THE BOARD

January 25, 1982

The Honorable Tom Corcoran
United States Congressman
1107 Longworth House Office Building
Washington, D.C. 20515

Dear Congressman Corcoran:

Thank you for your letter of December 23 inviting CP National's comments on proposed amendments to the Public Utility Holding Company Act that would be achieved through your introduction of H.R. 5220. You also solicted other approaches including total repeal.

We are very appreciative of your concern for the financial health of our nation's public utility companies and for your introduction of legislation permitting public utility diversification that would provide an apportunity for utilities to bring earnings to a reasonable level. We at CP National have begun to develop our own diversification program.

We favor total repeal of the Act. However, we believe that any amendments to the Holding Company Act that would relieve restrictions relating to diversification would be of considerable assistance.

Sincerely,

Ben

Ben W. Agee
President and Chairman

BWA:jlw

cc: Edison Electric Institute
National Association of
Regulatory Utility Commissioners

al

1355 WILLOW WAY, CONCORD, CA 94520, P.O. BOX 4032, CONCORD, CA 94524 (415) 680-7700

VIRGINIA ELECTRIC AND POWER COMPANY
RICHMOND, VIRGINIA 23261

January 28, 1982

O. J. PETERSON, III
VICE PRESIDENT
AND TREASURER

The Honorable Tom Corcoran
1107 Longworth House Office Building
Washington, D. C. 20515

Dear Representative Corcoran:

Justin Moore gave to me your letter of December 23 regarding H.R.5220 which you have introduced to amend the Public Holding Company Act. I apologize for the delay in replying to your letter, but with the holidays, the bad weather and my travel schedule, I have fallen behind on correspondence.

You had inquired about our views on amendment or repeal of the PUHCA. We believe that Congress should, at the very least, broaden the exemptions available under that statute, for the very reasons that you stated in your remarks introducing H.R.5220, but we also strongly support repeal of the PUHCA, provided that the introduction of such a repeal legislation has some reasonable chance of success and does not result in amendment legislation being dropped. The worst possible result, from our point of view, would be that no legislation of any sort is adopted.

Sincerely yours,

O. J. Peterson, III

PUBLIC SERVICE COMPANY OF OKLAHOMA
A CENTRAL AND SOUTH WEST COMPANY

P.O. BOX 201 / TULSA, OKLAHOMA 74102 / (918) 599-2000

PSO

BOOTH MOFFETT
VICE PRESIDENT,

January 18, 1982

The Honorable Tom Corcoran
U. S. House of Representatives
1107 Longworth House Office Building
Washington, D. C. 20515

Dear Mr. Corcoran:

Your letter of December 23, 1982, addressed to Mr. Fate has been forwarded to me for a reply.

In our response to your October 27, 1981 letter I stated that Public Service Company of Oklahoma is a wholly owned subsidiary of Central and South West Corporation and that we would not respond "as an independent operating company." I feel that the response from Central and South West Corporation will necessarily suffice for Public Service Company.

Very truly yours,

Booth Moffett

EBM:ed

al

PUBLIC
SERVICE
INDIANA

Hugh A. Barker
Chairman and
Chief Executive Officer

January 12, 1982

The Honorable Tom Corcoran
Congress of the United States
House of Representatives
Washington, D. C. 20515

Dear Representative Corcoran:

Thank you for your letter of December 23, 1981 enclosing a copy of H.R. 5220 and a list of the respondents to your October 27 letter. We have reviewed the proposed bill and endorse it as constructive legislation. This type of thoughtful deregulation is a step in the right direction.

Sincerely,

Hugh A. Barker

HAB:gm

al

Northern Indiana Public Service Company
General Offices / 5265 Hohman Avenue / Hammond, Indiana 46325 / Tel.: 853-5200 (219)

I. J. ROBERTS
VICE PRESIDENT

January 18, 1982

The Honorable Tom Corcoran
United States House of Representatives
1107 Longworth House Office Building
Washington, D.C. 20515

Re: H.R. 5220, Public Utility Financial Reform Act

Dear Congressman Corcoran:

Responsive to your letter of December 23, 1981, to Mr. Edmund A. Schroer, the Company is pleased that you introduced H.R. 5220. As a member of the group of electric and gas utility companies that have been working to amend the Public Utility Holding Company Act of 1935, we believe that the Reform Act you are proposing would lower significant barriers to utility diversification. It is our thought that diversification is one avenue toward promoting increased financial strength for the utility industry.

As you know, the Securities and Exchange Commission on December 21, 1981, wrote to Senator D'Amato urging repeal of the entire 1935 Act. In light of the Commission's judgment that the regulatory burden created by the 1935 Act is no longer warranted, we urge you and your colleagues to give serious consideration to repeal. We think Congressional hearings on the 1935 Act will demonstrate that vast changes in the utility industry and regulation since passage of the 1935 Act have combined to make its particular form of regulation unnecessary.

The Company thanks you for your leadership and consideration of the issue, and stands ready to help in whatever way it can.

Very truly yours,

IJR:mah

SOUTH CAROLINA ELECTRIC & GAS COMPANY
POST OFFICE BOX 764
COLUMBIA, SOUTH CAROLINA 29218

V. C. SUMMER
PRESIDENT
CHIEF EXECUTIVE OFFICER

January 12, 1982 *ac*

The Honorable Tom Corcoran
Representative in Congress
1107 Longworth House Office Building
Washington, DC 20515

Dear Congressman Corcoran:

Thank you for your letter of December 23, 1981, enclosing information relative to H.R. 5220, the "Public Utility Financial Reform Act," a bill which you introduced on December 15, 1981.

Our Company has been following the proposals to amend the Public Utility Holding Company Act of 1935 to facilitate diversification by electric and gas utilities into nonutility businesses. We believe that H.R. 5220 would be highly beneficial to the utility industry and could lead to a means of improving the industry's financial performance and stability and thus contribute to the well-being of the Nation's energy resources.

We are asking all members of our South Carolina Delegation to support this bill as being in the best interest of the electric and gas industry and their customers.

Very truly yours,

Virgil C. Summer

Virgil C. Summer

lhf

PACIFIC GAS AND ELECTRIC COMPANY

77 BEALE STREET · SAN FRANCISCO, CALIFORNIA 94106 · (415) 781-4211

FREDERICK W. MIELKE, JR.
CHAIRMAN OF THE BOARD

[illegible]

January 12, 1982

Hon. Tom Corcoran
1107 Longworth House Office Bldg
Washington, D.C. 20515

Dear Representative Corcoran:

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Thank you for your letter of December 23, 1981, enclosing a copy of HR 5220, the "Public Utility Financial Reform Act," which you introduced on December 15.

As Mr. J. E. Koehn indicated in his letter of November 25 on this subject, PGandE strongly supports repeal or reform of the Public Utility Holding Company Act to allow utilities greater flexibility to organize their business activities and to restore their financial health. HR 5220 goes a long way towards achieving this goal.

As noted in the materials Mr. Koehn sent, however, the desired positive effect of this legislation will not be achieved unless language is included to clarify that an existing combination gas and electric utility company will be construed to be a single public utility subsidiary for the purposes of the "single subsidiary" exemption. I have enclosed suggested language to accomplish this change which I hope you will seriously consider inserting in HR 5220. Without this addition, the bill will be of little relevance to PGandE and the many other similarly placed combination gas and electric utilities throughout the nation.

We look forward to working with you on this and other proposals to reform or repeal the Act. If our Washington Office can be of assistance, please do not hesitate to let Ralph Dewey or John Vance know (1050 - 17th Street, N.W., Suite 1180, Washington, D.C. 20036; telephone 296-8656).

Sincerely,

Frederick W. Mielke

FWM:mm

cc J. E. Koehn
Ralph Dewey
John Vance

AMENDMENT TO HR 5220 AS INTRODUCED ON DECEMBER 15, 1981

Amend Section 4 of the bill as follows (additional language underscored):

"Sec. 3. (a)

"(6) such holding company has only one subsidiary public utility company and such subsidiary public utility company's operations as such do not extend beyond the State in which it is organized and States contiguous thereto. For the purposes of this subsection, a combination gas utility company and electric utility company in existence on December 15, 1981, shall be deemed to be a single public utility company."

MISSISSIPPI POWER & LIGHT COMPANY
Helping Build Mississippi
P. O. BOX 1640, JACKSON, MISSISSIPPI 39205

DONALD C. LUTKEN
PRESIDENT

January 5, 1981

Honorable Tom Corcoran
United States Representative
1107 Longworth House Office Building
Washington, D.C. 20515

Dear Congressman Corcoran

Your interest in the adverse effects of the Public Utility Holding Company Act is deeply appreciated.

In response to your letter of December 23, 1981, I feel very strongly that the Act has adequately served its original purpose and now has no useful function.

Subsequent to the adoption of the Act nearly fifty years ago, the Congress has adopted other safeguards that protect the public from any recurrence of the events which led to passage of the Act.

I hope you can sponsor legislation which repeals this cumbersome, restructive and obsolete statute.

Sincerely

DCL:sb

cc - Mississippi Congressional Delegation
System Chief Executive Officers
System Public Affairs Committee

TECO ENERGY, INC.
P. O. BOX 111
TAMPA, FLORIDA 33601

H. L. CULBREATH
PRESIDENT

January 6, 1982

The Honorable Tom Corcoran
Representative in Congress
1107 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Corcoran:

I am responding to your request for comments on the proposed legislation amending the Public Utility Holding Company Act of 1935.

We are supportive of H.R. 5220 which you introduced in December. The electric and gas utility industries should be permitted to develop prudent programs of diversification into non-utility activities within the parameters of state regulation.

Such diversification would be more appropriate in a holding company structure so as to distinguish clearly between utility and non-utility operations. The electric and gas industries should have the opportunity to pursue the normal business practice of diversification; the '35 Act makes that impossible for some companies, very difficult for others.

The "unless and except" clause (section 3, paragraph[a]) in the Act can be a major deterrent to the use of the holding company structure and therefore to diversification; it should be removed, as provided for in your bill.

We believe that carefully managed non-utility businesses through time may well improve the financial performance of the electric and gas industries. Any improvement in the financial characteristics of our industries would clearly benefit both our customers and our investors.

If I can be of assistance to you in any aspect of this work, please let me know.

Sincerely,

H. L. Culbreath

KANSAS CITY POWER & LIGHT COMPANY
1330 BALTIMORE AVENUE
P. O. BOX 679
KANSAS CITY, MISSOURI 64141

January 5, 1982

ARTHUR J. DOYLE
CHAIRMAN OF THE BOARD
AND
PRESIDENT

The Honorable Tom Corcoran
Congress of the United States
House of Representatives
1107 Longworth House Office Building
Washington, D. C. 20515

Dear Mr. Corcoran:

We appreciate your efforts in seeking amendments to the Public Utility Holding Company Act and support the approach you have taken in H. R. 5220.

Sincerely,

AJD:be

Bay State Gas Company
Corporate Offices
120 Royall Street
Canton, Massachusetts 02021
Area code - 617-828-8650

December 30, 1981

Honorable Tom Corcoran
House of Representatives
1107 Longworth House Office Building
Washington, DC 20515

Dear Congressman Corcoran:

Your letter to our Chief Executive Officer, Charles Tenney II, has been forwarded to me. I have read your proposed "Public Utility Financial Reform Act" with great interest. The corporate diversification, it would permit, is essential to provide the corporate financial strength necessary in the energy industry today. Such financial strength benefits both customers and shareholders alike. If the energy industry is expected to provide services in the most efficient and cost effective manner, it must be permitted the corporate flexibility that makes the free enterprise system work.

I have discussed the provisions of S.1869, S.1870 and S.1871 with Senator Paul Tsongas and will speak with him further about HR 5220. As I meet with the several U.S. Representatives in Massachusetts from time to time, I plan to indicate our keen interest in the passage of your legislation.

Very truly yours,

BAY STATE GAS COMPANY

John D. Sampson
Vice President

Wisconsin Power & Light Company
Investor-owned Energy
222 West Washington Avenue P. O. Box 192 Madison, Wisconsin 53701 Phone 608/252-3311

EXECUTIVE OFFICES

December 31, 1981

The Honorable Tom Corcoran
U.S. House of Representatives
1107 Longworth House Office Building
Washington, D.C. 20515

Reference: H. R. 5220
Your Letter December 23, 1981

Dear Congressman Corcoran:

I believe our letter of December 9, 1981 was responsive. However, if we have missed something, please let me know.

We sincerely appreciate your interest and attention to this very important matter.

Best regards.

Sincerely yours,

James R. Underkofler
President

JRU:bkr

MIDDLE SOUTH UTILITIES, INC/BOX 61005
NEW ORLEANS, LA 70161/(504) 529-5262

FLOYD W. LEWIS
CHAIRMAN/PRESIDENT

December 29, 1981

[illegible] Nov. 27,

Honorable Tom Corcoran
United States House of Representatives
1107 Longworth House Office Building
Washington, D.C. 20515

Dear Congressman Corcoran:

Thank you for your letter of December 23, 1981, in which you enclosed a copy of H.R.5220 the "Public Utility Financial Reform Act".

While H.R.5220 would allow many electric utilities the flexibility to form holding companies without being subject to the outdated requirements of the Public Utility Holding Company Act of 1935; it unfortunately does nothing in regard to providing relief to the twelve holding company systems which are presently subject to the Act.

You will recall that my letter of November 27, 1981, in response to your questionnaire, suggested that the Public Utility Holding Company Act be repealed. Since my correspondence with you, two significant events have occurred. The first was the recent unanimous recommendation of the Commissioners of the SEC that the Act be repealed. The second was the introduction of S1977 by Senator J. Bennett Johnston to repeal the Act. Senator Johnston introduced S1977 without prior knowledge of the recommendation forthcoming from the SEC Commissioners.

In light of these developments and your desire to pursue a course of action that will bring about positive results for all concerned parties, I hope you will consider the sponsorship of repeal legislation in the House.

Your continued interest in this issue is certainly appreciated and we hope that hearings can be scheduled as soon as possible after Congress reconvenes.

Sincerely,

F W Lewis

FWL:daa
cc: Senator J. Bennett Johnston
Representative Billy Tauzin
Mr. Bill Timmons

Washington Gas
WASHINGTON GAS LIGHT COMPANY

DONALD J. HEIM
PRESIDENT

December 23, 1981

Representative Tom Corcoran
Longworth House Office Building
Room 1107
Washington, D.C.

Dear Congressman Corcoran:

First, we would like to express our appreciation to you for the opportunity to express our opinions on the questions posed by you in the attachment to your letter of October 27, 1981. You are exploring matters which are of great concern to this company and which are also matters of great national concern.

Any regulatory scheme that impedes the most efficient utilization the economic and financial resources of this country must be eliminated. In our opinion, the Public Utility Holding Company Act (which we will refer to throughout our response as the "1935 Act") constitutes a formidable obstacle to the maximum utilitization of the resources and the management talent of companies in the energy industry. It is imperative that its role, its functioning, its utility and its continued viability be critically and carefully examined and we are pleased that you have undertaken such an examination.

First, Washington Gas Light is exempt from the 1935 Act by virtue of Section 3(a)(2) since, while Washington Gas Light is a holding company in the technical sense, it is primarily an operating company whose distribution operations are confined to contiguous areas; namely, the District of Columbia, Maryland and Virginia. We have two small gas distribution subsidiaries and several non-utility subsidiaries, including one which is actively engaged in exploration for, and the production of, gas in Oklahoma.

As a consequence of the exemption which Washington Gas Light enjoys, it is not subject to the strictures of the 1935 Act. However, its exemption is subject to elimination or restriction at any time if the Securities and Exchange Commission finds that the basis for the exemption no longer exists. A simple example will demonstrate the problem. Like most corporations we are continuously reviewing the structure of our corporation and the means by which changes might be made in it to maximize our iciency and our ability to use the resources available to us. Among the several options which we have from time to time considered is the option of restructuring ourselves by creating a holding company which would own all the stock of the present Washington Gas Light and which would also hold directly, rather than through Washington Gas Light, the stock of the present Washington Gas Light subsidiaries. If this were done, our exemption would be lost and we would become subject to the full scope of regulation under the 1935 Act. Similarly, if we were to engage in a diversification program less closely related to the production and distribution of gas than our present program, there is a strong possibility that the Commission would, as it did several years ago in the case of Pacific Lighting Corporation, seek a revocation of the exemption.

Thus, while Washington Gas Light is exempt from the 1935 Act, it is severely inhibited in restructuring itself in the manner which management might believe offers the greatest opportunity for the utilization of its resources and in extending its activities in ways that would benefit its shareholders.

We believe that our comments can be most helpful to you if we respond to approaches one and two jointly rather than discretely; so that is how we shall respond.

First, we believe that the most favorable approach, at least insofar as gas distribution companies are concerned, would be the repeal of the 1935 Act, or at least the grant of an exemption from it to gas holding companies. If for any reason such a broader approach is not practicable or desirable, then we believe the second approach suggested by you, the grant of an exemption to holding companies having only one public utility subsidiary whose operations are limited to the state of incorporation and contiguous states and to holding companies created by companies presently exempt under Section 3(a)(2) of the 1933 Act and the elimination of the "unless and except" clause in the 1935 Act, would be desirable.

In responding to the specific questions posed under your approaches, it is essential the events and practices which led to the 1935 Act be reviewed and that changes in the industry, the economy, financial practices, securities regulation and accounting and auditing procedures be recognized.

Prior to 1935 there had developed in this country vast, sprawling utility complexes. These had grown with little or no concern for the interests of consumers or investors. They were characterized by hit-and-miss acquisitions all over the country; extremely unsound financial practices often involving excessive debt and control exercised by relatively small holdings of common stock; improvident contracts between the holding companies and their service subsidiaries and the operating subsidiaries; the bleeding off of profits from the operating companies; and a host of other abuses. These were documented in an eight-year study done by the Federal Trade Commission in the late '20s and early '30s, the findings of which study formed the foundation for the 1935 Act.

Prior to 1935 the quality and quantity of regulation of utility activities by the states was for the most part weak and ineffective. Moreover, Supreme Court decisions had severely limited the ability of the states to secure information with regard to holding companies and their diverse activities and to control the financial practices of the holding companies and contracts between them and their subsidiaries. Moreover, the continuous reporting requirements of the Securities Exchange Act of 1934 were new and their effect unknown. Moreover, only companies listed on registered securities exchanges were subject to those disclosure requirements. The financial industry had, prior to 1935, too often been "accomplices" in effectuating the unsound financings of the holding company complexes. The accounting profession had not developed sophisticated accounting and auditing practices such as we have today.

In that environment, it may fairly be said that the 1935 Act was a salutary and wise piece of legislation (although, ironically, given the vast and recognized extent of the abuses, it carried in the Senate by a single vote margin).

The heart of the 1935 Act was Section 11, which gave the Securities and Exchange Commission the power to restructure public utility holding companies into financially and geographically integrated and coherent structures. It may fairly be said that virtually everything else in the Act was ancillary to Section 11 and that the other provisions were largely intended to forestall the recurrence of past abuses and provide assurances of continued integrity.

By the mid-1950's the Securities and Exchange Commission in what can only be described as a superb achievement had virtually completed the job of restructuring the holding companies in accordance with the standards of Section 11. A number of the holding companies had reorganized themselves in a fashion that won them an exemption from the Act; the others, those which were required to register under the Act, were geographically and financially sound.

Since 1935 the activity of the Securities and Exchange Commission in administering the 1935 Act has been largely confined to the approval of financings, the review of applications for exemption, administration of the disclosure requirements, reviewing acquisitions proposed by registered companies and similar activities.

Vast changes have occurred in the utility and financial world. Under the Securities Exchange Act of 1934, the Securities and Exchange Commission has erected a formidable system of disclosure that applies, not only to all listed companies, but to any company with more than $1 million in assets and 500 shareholders; all registered holding companies, and virtually all other utilities of any significant size, are subject to the disclosure requirements of the 1934 Act. Moreover, as a result of increasing sophistication among analysts, utility companies have been increasingly pressed by market forces to maintain their financial integrity lest their ability to finance replacement and expansion of facilities be severely hampered. Thus, any utility proposing an unsound financing would find it extremely difficult to secure the assistance of a responsible underwriter, its rating would be impaired, the marketability of its securities would be hampered, and it would pay exhorbitant interest for its borrowings, a circumstance which would undoubtedly subject it to significant scrutiny and perhaps adverse ratemaking action by state authorities.

Moreover, many of the constitutional restrictions on the activities of state public utility commissions perceived by the Supreme Court prior to 1935 are no longer seen today. Thus, it is accepted that state commissions have extensive powers to regulate, in most instances, contracts between distribution companies and their parents and service subsidiaries of the parents. Furthermore, the sophistication, the skills and the aggressiveness of state authorities have increased immensely since 1935; in addition, legislatures have accorded to such authorities significantly greater power than they once had. Thus, through their ratemaking power, state commissions can control and inhibit many of the activities which existed before the 1935 Act.

The accounting profession has refined greatly accounting and auditing standards and the sense of responsibility in the accounting profession to exercise independent judgment with regard to the financial statements audited by its members has vastly increased. It would be impossible today for a public utility holding company to engage. in the financial and accounting practices of the pre-1935 period and secure a favorable opinion from its auditors.

Thus, for a host of reasons, it is virtually inconceivable that the abuses which predated 1935 would arise again. State regulatory authority, market forces, heightened sense of responsibility on the part of financial institutions and auditors, realization that such abuses would quickly lead to liability and disciplinary action, all these combine to assure that the abuses intended to be remedied by the 1935 Act would not recur.

In the foregoing are implicit the answers to the specific questions which you have asked under approaches one and two.

With respect to question 1 under approach one, at the present time utility companies do not present the problems of size and complexity the 1935 Act was intended to correct. As indicated above, by the 1950s the complexities that attended holding companies prior to the 1935 Act had been successfully eliminated by a combination of voluntary action by the holding companies and regulatory mandate by the SEC. Of course, many of the utility holding companies as well as many of the utility companies not parts of holding company complexes are large corporations by any standards. However, there is no evidence that their size poses any regulatory or economic problems; rather, in most instances, such size results in economies of scale, better service to consumers, and more attractive opportunities for investors.

With respect to the second question under approach one, we believe that, were the 1935 Act repealed, remaining federal and state laws would adequately protect the interests of stockholders and ratepayers. First, with regard to ratepayers, the repeal of the 1935 Act would in no way diminish the regulatory authority of the Federal Energy Regulatory Commission which would continue to have jurisdiction over the wholesale price of gas, and the present restrictions with regard to the price of gas at the wellhead would continue pursuant to the program for decontrol incorporated in the Natural Gas Policy Act. Similarly, the powers of the state commissions would continue unabated and they would continue to have jurisdiction to establish rates and perform a number of functions collateral to that, including, in many instances, review of the propriety and fairness of contracts with affiliates of distribution companies. Consumers are obviously concerned with the continuity and reliability of service and the rates they pay for energy. These are the primary concerns of the state regulatory authorities and there is no reason to believe that the effectiveness of that regulation would be impeded were the 1935 Act repealed.

Investors in publicly held companies in general are protected under the provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. It has been the prevailing philosophy of federal securities regulation that investors be given all material information and that, possessing that, they have the unimpeded right to make their own judgments with regard to specific investments. The federal securities laws in general clearly repudiate the "paternalistic" notion that in some fashion the federal government should intrude itself in the investment process beyond assuring that all material information is available to investors. This system has worked effectively for the overwhelming bulk of American industry. There is no reason to believe that investors in public utility holding companies need or should have an additional measure of protection such as that purportedly now afforded by the 1935 Act. Moreover, the investors are further protected by considerations discussed above, namely, the enhanced integrity of the financial community, the independence of the accounting profession, the development of sophisticated accounting and auditing standards, the high quality of financial analysis and a number of other factors. Because of the weaknesses that existed before 1935 in accounting standards as well as financial practices in underwritings and the absence of an extensive and well trained analyst community, it may have been desirable to afford investors in public utility holding companies the additional protections given by the 1935 Act, but such is no longer the case.

In answer to question 3 under approach one, it is difficult to imagine that the repeal of the 1935 Act would result in any greater conflict in state regulation than presently exists. Washington Gas Light is subject to the regulatory authority of the District of Columbia and the states of Maryland and Virginia, but it is not subject to the regulatory authority of the SEC under the 1935 Act. Our experience is that, while occasionally there may be problems with respect to the allocation of assets among operations in the three jurisdictions in connection with ratemaking proceedings, those problems have generally been satisfactorily resolved in a manner that is consistent with the interests of consumers and investors.

There is little reason to think that if Washington Gas Light were subject to the Public Utility Holding Company Act there would be any abatement of these problems.

With respect to question 4 under approach one, it is doubtful whether members of the public have any awareness that the holding companies which own the operating companies with which they are familiar and with which they deal are subject to a separate scheme of federal regulation. They are generally only aware that they purchase their gas or electricity from the local utility and they perceive that the activities of those utilities are regulated by state authority. We suspect that any sort of opinion survey would disclose almost total ignorance by the public of the existence of the Public Utility Holding Company Act and its operations and provisions. Thus, it is extremely unlikely that the repeal of the Act would have any effect upon the confidence of the public.

The answer to question 5 under approach one we believe is fairly indicated above. The powers of the state public utility commission would, as indicated, continue unabated. It is conceivable that in some instances where the statutory basis of regulation in a state was perceived to be inadequate the repeal of the Act might lead to legislation strengthening the powers of the state authorities. Inasmuch as there are among the states a variety of statutory provisions, it may well be that the repeal of the Act would lead to a greater uniformity among state statutes, with weaker statutes being supplemented or replaced by stronger provisions. The stockholders of public utility holding companies would be placed in the same position as the stockholders of other publicly held corporations: they would, as they do now in making other investments, rely upon disclosure in making their decisions; the financial reports furnished to them would continue to be prepared in accordance with generally accepted accounting principles adopted by the accounting profession under the oversight of the Securities and Exchange Commission; such statements would be accompanied by reports of independent auditors subject to statutory and professional requirements to insure integrity. In short, they would have the same protections as investors in other companies. Ratepayers today are principally protected by the state regulators who set the rates and it is doubtful whether the effectiveness of this rate setting would be adversely affected by repeal of the 1935 Act, particularly in states which gave their regulators statutory authority over contracts with affiliates and authority to secure information with regard to the activities of holding companies.

With regard to the utilities themselves, for the most part the operating companies would operate in the same fashion in which they presently do. Each of them is subject to the state authority and must satisfy those authorities with regard to their requests for modifications of rates. Similarly, they are subject to a number of penalties if they fail to provide adequate service. It is probable that their mode of operation would continue exactly as it is presently.

With regard to diversification, it is likely that repeal of the 1935 Act would result in greater diversification on the part of holding companies presently registered and on the part of companies which are exempt, but which have foregone opportunities for diversification because of concern over the loss of their exemption. Diversification is an extraordinarily complex subject. However, there is no reason to believe that, given the opportunity, utility holding companies would diversify in ways that are inimical to the public interest or the interests of consumers or the interests of investors. State authorities, with their extensive ratemaking powers, would be able to determine whether diversification is inappropriately bleeding resources away from the operating companies, and if so the shareholders of the holding company could be penalized through ratemaking.

The inability of public utility holding companies to diversify their activities exacts many penalties. Statistical evidence suggests that the cost of financing for holding companies exceeds in many instances the cost for other similarly situated companies which are not subject to the constraints of the 1935 Act. Similarly, it is more difficult for such companies to recruit aggressive, dynamic management because they afford only limited opportunities for imaginitive use of resources. Moreover, many businesses engaged in activities similar to those engaged in by holding companies can and have diversified successfully -- for instance, utilities that are totally intrastate, interstate pipeline companies and the like.

The limited experience of Washington Gas Light with permissible diversification is an example of the benefits that can flow to investors and to consumers. The company has been engaged in gas exploration and production activities in Oklahoma. This has had a favorable effect upon the price of the stock of the company, and may reasonably be expected to have a favorable effect upon the Washington Gas Light's ability to engage in equity or debt financing. To the extent that these results follow, the cost of providing service to consumers of gas will be reduced. This will be reflected in their rates, and at the same time investors will receive a better total return on their stock.

We trust that these views will be of assistance to you in appraising the benefits which would flow from (a) a total repeal of the 1935 Act, (b) an exemption of gas utility holding companies from it, or (c) a more limited exemption as outlined in your proposal two.

If we can be of further assistance to you in analyzing these problems, we hope you will feel free to call upon us.

Yours very truly,

Donald J. Heim
President

NSP

Northern States Power Company

414 Nicollet Mall
Minneapolis, Minnesota 55401
Telephone (612) 330-6606

Arland D. Brusven
Secretary and Financial Counsel

December 15, 1981

The Honorable Tom Corcoran
1107 Longworth House Office Building
Washington, D C 20515

Dear Congressman Corcoran

This document is the response of Northern States Power Company, a Minnesota corporation, to your request for comments on the Public Utility Holding Company Act of 1935. The Company is an "exempt holding company" pursuant to order of the Securities and Exchange Commission. The Company's principal subsidiary is Northern States Power Company, a Wisconsin corporation, which provides electric and gas service in the western portion of the State of Wisconsin. (Under Wisconsin law, only domestic corporations may be engaged in the business of a public utility within the State of Wisconsin.) Under an agreement between the Company and Lake Superior District Power Company dated December 29, 1977, the Company proposes to affiliate with Lake Superior District Power Company, a Wisconsin corporation. An application to the Securities and Exchange Commission was filed in January, 1978, seeking an order for approval of the affiliation under the Public Utilities Holding Company Act and for a continuing exemption under the Act, except for Section 9(a)(2). The Securities and Exchange Commission has not yet issued an order on the Company's application. If an order of the SEC approving the transaction is received, the Company will have two public utility subsidiaries.

Proposal for amendment to the Public Utility Holding Company Act of 1935

Northern States Power Company does not propose the repeal of the Act. The goal of seeking reasonable latitude for our Company's operations does not require the total removal of limits on those activities and structures that were perceived to be abusive practices prior to the enactment of the Act. However, the law should be amended to permit rationalization of the corporate form consistent with interests of shareholders and consumers and to preclude the application of various criteria by the Securities and Exchange Commission which represent significant impediments to management actions which are not abusive to the interest of shareholders and customers.

For the purposes of this discussion, "Approach Two" is proposed as the basis for amending the law; however, the amendment of the law should be expanded within the following criteria for an exemption upon order by the SEC:

1 Permit a "single layer" public utility holding company structure, irrespective of whether the holding company is "predominently a public utility company" and the number of public utility company subsidiaries provided all public utility subsidiaries operate within the state of incorporation of the holding company and in contiguous states. (Whether non-public utility subsidiaries extend the corporate structure to more than a single layer below the holding company or there are non-public utility activities outside the contiguous states should be irrelevant.)

2 Permit affiliation or merger between a "public utility holding company" and another public utility system provided that the acquired or merged publuc utility system meets the standards of an "integrated public utility system" under Section 11 of the Act and is within the state of incorporation of the holding company or contiguous states.

3 Permit affiliation or merger between or with a combination public utility without divestiture of the natural gas utility.

4 Permit the reorganization of an existing exempt holding company structure or existing public utility company within the above criteria.

5 Preempt state jurisdiction over the creation of separate corporate entities and the transfer of assets between affiliated entities to accomplish a corporate reorganization within the proposed criteria.

6 Require action by the SEC on any application under the Act within 18 months after filing of the application, with one extension not exceeding six months by order of the SEC if there is a reasonable question that the action for which the application is made is not consistent with the Act and there is reasonable cause for the delay. If the order is not issued within 18 months, or the extended date by order of the SEC, upon application by the applicant, the SEC shall issue its order within ten days approving the application.

Supplemental discussion of proposal

The most significant result of "Approach Two" and the additional proposals is the removal of the "unless and except" clause and the requirement that an exempt holding company must be "predominently a public utility". As long as the law permits the SEC to apply criteria of the nature it has developed to the ratios between parent and subsidiary revenues, between electric and gas revenues, and between utility and non-utility in the grant of an exemption, in the continuation of an exemption, and upon review of an exemption, there is continuing jeopardy to any investment made by the affiliated group. Such ratios frustrate the creation of, and the continuation of, separate corporate entities for public utility operations based on state boundaries, for different utility operations, or other business activities.

A related problem associated with operation in various states is the disparate treatment by the state regulatory agencies on applications by a multi-state utility. The usual constraints on the transfer of assets to a separate corporate entity subject to state approval is a significant impediment to rationalizing the operation based on state jurisdictional boundaries. The difficulties incurred by public utilities arising from such multi-state jurisdiction can be modified by determinations by the Federal Energy Regulatory Commission on wholesale rates for electric and natural gas exchanged between separate "public utilities" which includes the separate affiliated entities.

Effect of enactment on state public utilities commissions, the utilities, stockholders, and ratepayers

With the federal regulatory scheme for rates by "public utilities" for electricity and natural gas sold at "wholesale", the ratepayers of each of the affiliated "public utilities" will be protected.

Since the "quality" of a public utility's earnings and its capital structure are a significant element in its capital costs, this would permit a mechanism to establish a fairer treatment of all ratepayers because it would restrict the ability of a single state to permit its ratepayers to "ride" on the quality provided by ratepayers in another state, the benefit of which inures to all ratepayers. Thus the ratepayers of a multi-state utility can be better protected from each other.

The utilities will be able to rationalize the corporate structure consistent with regulatory requirements for public utility operations and to utilize financing techniques and capital structures for non-utility businesses consistent with business considerations which may be different from financing public utility operations. The stockholders have the potential to invest some of their "reasonable return" from the utility operations in other activities which could improve the attractiveness of the securities for the benefit or ratepayers as well as stockholders. The potential of the SEC to destroy the benefits of successful diversification or changes in the relationship of the various revenue areas of an affiliated group should be removed by amendment of the Act. In many instances, it is imperative that the law be changed before "non-utility" businesses can be realistically pursued by an exempt holding company or its affiliated companies.

Northern States Power Company has no present intention of becoming a "diversified company". It is expected that providing public utility services will be the dominent business of the affiliated group irrespective of corporate structure. However, the Company is evaluating alternatives in which it can diversify the use of its facilities and expand the employment of expertise used in its electric and natural gas operations and to better its utility operations. As the Act is currently constituted as interpreted by decisions of the SEC, it represents restrictions and potential jeopardy to the Company in even that limited a scope of broadening its business activities and change of corporate structure.

The foregoing comments are provided from the viewpoint of an "exempt public utility holding company" with integrated operations in four states, including a subsidiary in one state and seeking SEC approval for the acquisition of another public utility. It is our reaction that specific difficulties presented by the Act for our operations can be remedied by amendment of the Act as proposed in "Approach Two" with some embellishments.

Very truly yours

ARLAND D BRUSVEN
Secretary and
Financial Counsel

Wisconsin Power & Light Company
Investor-owned Energy
222 West Washington Avenue P O Box 192 Madison, Wisconsin 53701 Phone 608/252-3311

December 9, 1981

EXECUTIVE OFFICES

The Honorable Tom Corcoran
U. S. House of Representatives
1107 Longworth House Office Building
Washington, D. C. 20515

RP

Dear Congressman Corcoran:

We appreciate the opportunity to respond to your letter of October 27 wherein you ask for our comments to two legislative approaches at amending the Public Utility Holding Company Act of 1935.

Wisconsin Power and Light Company would generally favor Approach Two outlined in your letter of October 27, 1981. The question presented is how best to accommodate diversification with regulation of public utility operations. It is, of course, essential that utility operations and accounting should be wholly separate from and insulated to the extent possible from nonutility operations. This can best be accomplished by an exempt holding company with separate and distinct corporate subsidiaries.

The removal of the "unless and except clause" is significant in providing management with incentive to diversify. If an exemption is lost under that clause, the holding company may be required to divest one or more subsidiary businesses, or subjected to additional and burdensome regulation.

Enactment of Approach Two, absent overreaction by state regulators, would facilitate diversification. More importantly, it would provide incentive to accomplish diversification through a holding company structure. This structure provides the best opportunity to enhance the rate of return to the utility investor, while sheltering utility customers and assets from risk.

I would be happy to discuss this further and provide any additional information that you might need. Your interest and support for this legislation is most appreciated.

Sincerely,

Edw. A. Wiegner

Edward A. Wiegner
Executive Vice President

EAW:ecd

cc: Mr. J. R. Underkofler

CENTRAL ILLINOIS PUBLIC SERVICE COMPANY
GENERAL OFFICES
607 EAST ADAMS • SPRINGFIELD, ILLINOIS 62701 • 217/523-3600

December 8, 1981

Hon. Tom Corcoran
U. S. Representative
1107 Longworth Office Bldg.
Washington, D.C. 20515

Dear Tom:

ap

This letter will respond to your correspondence of October 27, 1981 regarding the Public Utility Holding Company Act of 1935. We would like to express our appreciation for the opportunity to once again comment on a matter of interest to our Company and apologize for not getting back to you by November 25. However, we touched base with Al Cobb who informed us we still had plenty of time to submit comments.

We also wish to commend you for the attention you have given to this sensitive issue. We understand you have spent many hours listening to presentations of interested groups, even though it meant you had less time to devote to other matters. Please believe me when I say that we appreciate your efforts.

As you by now are aware, the utility industry is not entirely agreed on which, if any, strategy to pursue concerning possible changes to the Act. With respect to your questionnaire, we will address "Approach One" and "Approach Two" separately and conclude with a few general comments.

"Approach One" suggests outright repeal of the Act with the exception of any proceedings already underway. While we may agree with this approach in principle, we would suggest it might be politically impractical and publicly unpopular. From a philosophical perspective, we would agree that local government, i.e., the Illinois Commerce Commission and other state regulatory and enforcement agencies are capable of establishing and administering programs which would accomplish the objectives of the Holding Company Act. There are, of course, other regulatory constraints available to FERC and the anti-trust division of the Department of Justice.

If the Holding Company Act was repealed in its entirety, we don't believe there would be a noticeable difference in the status quo. We believe current state and federal law other than the Holding Company Act is sufficient to protect the public, ratepayers and shareholders.

You ask whether the public has enough confidence in state PUC's to reduce the federal role in regulation of local utilities. Even though the public may not have total confidence in the ability of state PUC's to administer federal programs, we believe the public has even less confidence in federal regulators. Given the opportunity to choose, we believe the public would opt for local administration.

Nevertheless, as stated earlier, we don't feel that total repeal of the Act would be acceptable from a political or public point of view even though it may be both desirable and justified. On this point, we would defer to your judgment.

"Approach Two", amending Section 3 of the Act to eliminate the "unless and except" clause, would seem to be more acceptable and we would support such an approach. As you know, our Company has been working with a group of other companies represented by the law firm of Reid & Priest. "Approach Two" is virtually identical to the position proposed by this group.

We support "Approach Two" because it addresses in a very specific manner a major impediment to utility diversification. The two remaining provisions of Approach Two (the contiguous states and one subsidiary) also cut right to the heart of the problem. In our opinion, this "rifle shot" attack would eliminate the problems facing those companies who may wish to diversify, and is much preferable to either repealing the Act or introducing three or four bills with varying remedies.

While we endorse and support the concept of "Approach Two", we want to make it clear that our company has no immediate plans for diversifying. We have studied diversification in the past and would expect to continue doing so. However, as long as providing reliable electric and gas service remains a viable business purpose -- which we believe it does -- we plan to continue doing what we know how to do best. It is for this reason amending the Act is not currently one of our top legislative priorities.

Obviously, if political wisdom dictates that now is the opportune time to achieve changes to the Act, we will support the effort on the basis that such change may be of use to us at some point in the future.

For those companies wishing to diversify into nonregulated businesses, we would agree that the holding company structure is the preferable organizational form. It serves to mitigate problems arising from forced cross subsidization between the regulated and diversified sides of a business.

In conclusion, we support the move to eliminate existing impediments to increased utility diversification as outlined in Approach Two, even though passage of such an amendment would not necessarily result in a move toward diversification by our company in the foreseeable future.

We hope our comments will be of some use to you in analyzing and developing a final position on this significant issue. If we can be of any further assistance, please don't hesitate to call.

Again, thank you for the opportunity to comment.

Sincerely,

Ken

Kenneth L. Andres, Manager
Public Affairs Department

OHIO EDISON COMPANY
76 SOUTH MAIN STREET, AKRON, OHIO 44308 · 216·384·5844

J. T. ROGERS, JR.
PRESIDENT

December 8, 1981

The Honorable Tom Corcoran
U. S. House of Representatives
1107 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Corcoran:

Your concern to foster the ability of utilities to help their investors and ratepayers is greatly appreciated. This letter is in response to your letter of October 27, 1981, respecting the Public Utility Holding Company Act.

Ohio Edison is a holding company subject to regulation under the Act although exempt since 1979 under Section 3(a)(2). Its utility operations are in Ohio. Operations of its utility subsidiary, Pennsylvania Power Company, are in the contiguous state of Pennsylvania.

One constraint on exploring diversification is Section 11(b) of the Act, contemplating that activities as an integrated public utility system should be limited "to such other businesses as are reasonably incidental to, or economically necessary or appropriate to the operations of such integrated public utility system". This Section is not an absolute barrier, but it tends to restrict exploration of options at a time when utilities should be encouraged to be resourceful in bettering their circumstances. Certainly, decisions to diversify will be dependent upon many complex factors; the opportunity to diversify, however, should not be denied because of the continued existence of a law that has in all probability outlived its usefulness.

Both of the approaches contained in the discussion paper attached to your letter would remove the constraints now presented by the Holding Company Act. Repeal would obviously have this effect, as would, in our case, amendment of the Act to remove the "unless and except" clause of Section 3(a). If, as has been widely suggested, the principal unique tasks for which the Act was created have been accomplished, and other Federal and State laws adequately protect investors and ratepayers, repeal of the Act would seem to offer the preferable solution.

Very truly yours,

Central and South West Corporation
2700 One Main Place • Dallas, Texas 75250 • 214-745-3703

DURWOOD CHALKER
Chairman and Chief Executive Officer

CP

December 4, 1981

Honorable Tom Corcoran
U.S. House of Representatives
1107 Longworth HOB
Washington, D.C. 20515

Dear Congressman Corcoran:

I sincerely appreciate the opportunity, on behalf of Central and South West Corporation, to respond to your recent letter wherein you sought our views on the Public Utility Holding Company Act of 1935 ("PUHCA").

Central and South West Corporation (CSW) is a registered electric utility holding company under PUHCA, and owns all of the outstanding common stock of four operating subsidiaries which, in turn, provide electric service to approximately four million people in Texas, Oklahoma, Louisiana and Arkansas. Regulatory commissions in these four states exercise jurisdiction over the retail rates and operations of our operating subsidiaries, and the Federal Energy Regulatory Commission also has jurisdiction under the Federal Power Act over certain System facilities and operations. As you are aware, the Securities and Exchange Commission has, in addition to its extensive authority under PUHCA, authority over CSW regarding securities registration, trading and investor disclosure under the Securities Act of 1933 and the Securities Exchange Act of 1934.

The questions accompanying your letter requested us to comment on two possible legislative options regarding PUHCA. Your second option would broaden the categories of exemptions

Central Power and Light Company • Public Service Company of Oklahoma • Southwestern Electric Power Company • West Texas Utilities Company
Central and South West Services, Inc. • Central and South West Fuels, Inc.

ELECTRICITY FOR THE SOUTHWEST

available to those public utility holding companies which are presently exempt from registration under PUHCA. Since CSW is a registered holding company, I must confine my responses to your questions on Approach One, that is, repeal of the present law.

Approach One

Question 1: To what extent, if any, do utility companies continue to present the problems of size and structural complexity the Act was intended to correct? Please specify?

Response: The problems of giant holding companies with complex intercorporate structures which had developed by the 1930's simply do not exist anymore. Within 20 years of its enactment, the Congressional mandate of PUHCA to reorganize and simplify the holding companies had been substantially completed by the SEC. In today's environment a registered utility holding company is a highly regulated but relatively simple corporate management device which seeks to coordinate the activities of a small number of operating companies. Unlike the era of highly leveraged and undercapitalized financial structures, utility holding companies strive to maintain economically optimum capital structures with appropriate levels of equity. While the SEC's regulatory authority under PUHCA eliminated such abuses, the capital markets have become so competitive and the securities registration and disclosure requirements so pervasive that holding company shareholders now enjoy the same protections afforded investors in all publicly held enterprises, with or without PUHCA.

Question 2: To what extent would federal and state law adequately protect the interests of stockholders and ratepayers were PUHCA to be repealed?

Response: I have already cited several other Federal laws and regulatory schemes in addition to PUHCA which presently serve to maintain the proper balance between, and therefore simultaneously protect, the interests of stockholders and ratepayers. At the state level, regulatory commissions have the authority to set the retail electric rates for customers of CSW's operating subsidiaries. Such commissions have exercised their powers through the ratemaking process to address issues such as allocation of costs between affiliates and between utility and non-utility interests to protect the interests of consumers and investors alike.

It is important to remember that PUHCA was passed by Congress in 1935 immediately following enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934. Taken as a whole, this legislation, enacted in the aftermath of the stock market crash of 1929, granted the SEC extraordinary powers over publicly traded corporate stocks. Obviously, the securities registration, trading, and disclosure requirements of the 1933 and 1934 Acts have had far broader impacts upon the capital markets than has PUHCA in terms of providing the general investing public with adequate information, and therefore, protection. Shareholders in CSW stock are afforded the same protection under these laws.

Question 3: Would the repeal of PUHCA result in conflicting state regulation? To what extent, if any, would this affect the public interest?

Response: In my judgment, the existence of PUHCA in truth has no effect on the question of conflicting state regulation since such conflicts can readily arise with or without PUHCA. At the time PUHCA was enacted, state regulation of utilities generally was scattered and essentially ineffective. Today, state regulation of utility rates and operations is the focus of public attention and has, in many instances, become highly sophisticated.

Question 4: Does the public have enough confidence in their state PUCs to reduce the federal role in regulation of local utilities?

Response: As I mentioned earlier, the state regulatory arena has become the focus of considerable public attention in recent years. Where the activities of state commissions and the SEC overlap or are duplicative, i.e., security issuance, diversification, and intercompany transactions, there is no apparent lack of public confidence in local regulation.

Question 5: In your opinion, how would repeal affect your state PUC, the utilities, stockholders, and ratepayers? In particular, to what extent, if any, would repeal of PUHCA lead to diversification?

Response: In our opinion, repeal or modification of PUHCA would have no adverse effect upon state regulation, utilities, stockholders or ratepayers. In fact, we strongly believe that relief from unnecessary and duplicative regulatory burdens would definitely be in the public interest in that it would allow utility holding companies to compete more efficiently and effectively for capital, human and technical resources, and other free enterprise opportunities. With respect to diversification, I would hope that the opportunity to carefully and prudently diversify would allow us to strengthen our respective financial and business positions, thereby benefiting our shareholders and our customers.

Again, let me commend you for your interest and efforts in this matter. Naturally, we will be greatly interested in any Congressional activity affecting the Holding Company Act.

Sincerely,

Durwood Chalker

Durwood Chalker

DC:ck

TEXAS UTILITIES COMPANY
2001 BRYAN TOWER · DALLAS, TEXAS 75201

BURL B. HULSEY, JR.
VICE CHAIRMAN OF THE BOARD

December 4, 1981

The Honorable Tom Corcoran
House of Representatives
1107 Longworth House Office Building
Washington, DC 20515

Dear Congressman Corcoran:

This is in response to your letter concerning possible amendments to the Public Utility Holding Company Act of 1935 (the Act).

As you know, the Act was passed in an attempt to correct a number of perceived abuses which had occurred in the utility business, notably excessive pyramiding of corporate structures and stock watering. At least partly as a result of the Act, as well as other state and federal legislation such as the Securities Act of 1933, those abuses are unlikely to recur.

As you pointed out, the electric utility industry in the United States is experiencing serious financial difficulties, despite frequent rate increases that have concerned consumers. It is difficult to raise the required capital on reasonable terms and most electric utility stocks sell at far below their book value. An apparent possible solution would be to allow utilities to diversify into more profitable non-utility business. Successful diversification could make the companies' securities more attractive investments, thereby reducing the cost of raising capital and benefiting investors and consumers.

The Act presents one impediment to such diversification even in the case of a company such as Texas Utilities Company, which is exempt from the Act under Section 3(a)(1). More specifically, the "unless and except" clause of Section 3 may allow the Commission to review diversification efforts in hindsight and possibly to revoke an exemption based on that review. If an exemption were revoked, a utility could be subject to the forced divestiture of the non-utility business as well as the additional regulation imposed by the Act upon registered holding companies. Obviously this element of uncertainty tends to restrict utility managements from undertaking significant diversification efforts. We are most interested in removing this uncertainty by the statutory elimination of the "unless and except" clause.

Since there are relatively few utility companies which have decided to undertake a diversification program and since the Act is only one element to be considered in such a decision, it is difficult to conclude definitively that amendment of the Act will lead to greater diversification. It appears, however, that the removal of this particular impediment could encourage diversification and thereby benefit customers and stockholders.

We appreciate your concern for the financial integrity of our industry.

Sincerely,

**PUBLIC
SERVICE
INDIANA**

Hugh A. Barker
Chairman and
Chief Executive Officer

December 3, 1981

Honorable Tom Corcoran
Congress of the United States
House of Representatives
Washington, D.C. 20515

Dear Mr. Corcoran:

In reply to your letter of October 27 with the attached questionnaire concerning the two legislative approaches to the Public Utility Holding Company Act of 1935 (Act), our Company has not had any experience with the Act since the late 1940s when the holding company of which we were a part was broken up. Therefore, our reply to your questions will have to be general.

APPROACH ONE.

Question 1. At the present time the problems of size and structural complexity the Act was intended to correct do not appear to be problems. Holding company systems have been integrated and, under present economic conditions, there have been no recent tender offers for the stock of independent operating companies, and due to the present unfavorable financial conditions of electric utilities, future tender offers are most unlikely. This is not to say that if the economics of electrical utilities were to improve to a marked degree, that tender offers would not be made for independent operating companies either on an integrated or non-integrated basis. In Indiana, there is only one electric subsidiary of a holding company, namely, Indiana & Michigan Electric Company. While construction and operating procedures of I&ME are largely based upon the integrated AEP system, the operation of I&ME in Indiana is quite similar to that of an independent electric utility. With respect to size, in these times of ever increasing expenses, a case can be made for merging, consolidating or placing under a holding company operating companies in order to save expenses resulting from larger scale and thereby reducing electric rates. Structural complexity

1000 East Main Street, Plainfield, Indiana 46168 317 .. 838 . 1242

can be controlled, as far as Indiana is concerned, by the Public Service Commission and at the Federal level by the Federal Power Act and the Securities Act of 1933.

Question 2. The recent situation in Wisconsin, where the Wisconsin Public Service Commission has asserted jurisdiction over proposals by Wisconsin Power & Light Company and Wisconsin Electric Power Company to reorganize to facilitate diversification, demonstrates that at least one state regulatory commission has determined that it has authority over the formation of holding companies. The SEC has apparently deferred action on the companies' applications for exemption under the Act. While there are no clear cut precedents for such action in Indiana, it must be noted that the Indiana Public Service Commission Act was patterned after the Wisconsin act. In our opinion, the existing Federal and State laws would adequately protect the interests of stockholders and ratepayers. To confirm this, however, legal research would have to be done.

Question 3. In our opinion, the repeal of the Act would not result in conflicting Indiana regulation and would not affect the public interest.

Question 4. If reduction of Federal regulation is confined to repeal of the Act, in our opinion, the public would have the necessary confidence in the Public Service Commission (Indiana Commission).

Question 5. Repeal of the Act might put an additional work burden on the Indiana Commission if, as in Wisconsin, the Commission assumed jurisdiction over diversification. With respect to the utilities, it might allow them to integrate and/or diversify more easily, depending on the reaction of the Indiana Commission. To the extent integration and/or diversification improved the financial picture of utilities, this would tend to improve the lot of shareholders. So long as we have ratemaking under the jurisdiction of the Indiana Commission for retail customers and under the Federal Energy Regulatory Commission (FERC) for wholesale customers, it is difficult to see how ratepayers would be affected by repeal of the Act.

APPROACH TWO.

Question 1. This amendment in and of itself will not lead to utility diversification. It will make it easier to diversify within the parameters of the amendment. Diversification for the sake of diversification is meaningless. It must be based upon sound economics and must hold out the attraction of greater earnings than can be made in the utility business.

Question 2. The amendment might put some additional burdens on the Indiana Commission depending upon the extent to which they can take jurisdiction over the diversification. The amendment would make it somewhat easier for the utilities to diversify within the parameters of the amendment. Repeal of the "unless and except" clause would assure the exempt companies that their exemptions would not be revoked and avoid the risk that diversification, if objected to after the fact by the SEC, could result in their being subject in full to the 1935 Act. To the extent diversification within the parameters of the amendment improved the financial picture of utilities, this would tend to improve the lot of the stockholders. So long as we have ratemaking under the jurisdiction of the Indiana Commission for retail customers and under FERC for wholesale customers, it is difficult to see how ratepayers would be affected by the proposed amendment.

Yours truly,

Hugh A. Barker

EUA

Eastern Utilities Associates

99 High Street, Suite 2830, Boston, Massachusetts 02110 Telephone (617) 357-9590
Address all correspondence to P.O. Box 2333, Boston, Massachusetts 02107

December 3, 1981

Honorable Tom Corcoran
U.S. House of Representatives
1107 Longworth HOB
Washington, D.C. 20515

af

Dear Congressman Corcoran:

I am pleased to reply on behalf of Eastern Utilities Associates to your letter of October 27 concerning the utility industry and proposals for changes in the Public Utility Holding Company Act of 1935 (PUHCA). I appreciate very much your interest in this matter.

As you probably know, Eastern Utilities Associates (EUA) is one of the utility holding companies registered under the PUHCA. It has two direct subsidiaries which are electric utility companies selling electricity at retail, one of these being Eastern Edison Company, organized and operating in Massachusetts, and the other being Blackstone Valley Electric Company, organized and operating in Rhode Island. An indirect subsidiary of EUA, Montaup Electric Company, is a Massachusetts corporation wholly owned by Eastern Edison Company and is in the business of generating, purchasing and transmitting electricity, which it sells only at wholesale, to Eastern Edison Company, Blackstone Valley Electric Company, and several unaffiliated utilities. In addition, EUA has a service company as a direct subsidiary which at the present time engages principally in providing various services to the other companies in EUA's holding company system.

The discussion paper enclosed with your letter deals first, as Approach One, with repealing the PUHCA, and it presents five questions under that approach. I have read the responses made to those questions in the letter of November 30, 1982 to you from Mr. Guy W. Nichols of New England Electric System. That system, though several times larger than EUA, strongly resembles the EUA holding company system both in its structure and with respect to the federal and state regulatory authorities to which it is subject. EUA is one of the seven electric utility holding companies mentioned in Mr. Nichols' letter as supporting amendments to the PUHCA embodied in S.1869 introduced on November 19th. Mr. Nichols' responses coincide so nearly with those which I would make that I think it would not be useful for me to set forth here a separate statement of my own views. Instead, I ask that you permit me to be recorded as concurring in those expressed in Mr. Nichols' letter.

Since Approach Two deals with exemptions for which EUA would not qualify, I think it appropriate for me to refrain from commenting on that approach.

Yours very truly,

John F. G. Eichorn

John F. G. Eichorn, Jr.
President

PUGET SOUND POWER & LIGHT COMPANY

PUGET POWER BUILDING • (206) 454-6363
BELLEVUE, WASHINGTON 98009

December 2, 1981

The Honorable Tom Corcoran
1107 Longworth House Office Building
Washington, D. C. 20515

Re: The Public Utility Holding Company Act of 1935

Dear Congressman Corcoran:

Thank you for your letter of October 27 and the opportunity to comment upon the possible repeal or amendment of the Public Utility Holding Company Act of 1935 (the "Act").

As you are undoubtedly aware, the regulatory burden on investor-owned electric utility companies has become particularly acute in recent years. Consequently, we share and appreciate your interest "in the possibility of removing federal statutory and regulatory barriers that may inhibit the ability of utilities to financially help themselves and their stockholders and ratepayers." We understand from your letter that you are considering the possible repeal or amendment of the Act as a step toward removal of these barriers.

Although Puget Sound Power & Light Company ("Puget") is not presently part of holding company system subject to the Act, Puget shares the interest of several utility companies in following the course of legislative proposals aimed at changing the Act. The holding company structure is conducive to diversification because it permits separation of various businesses for liability, rate-making and other purposes. However, the Act constitutes a substantial impediment to diversification through the holding company structure.

Although the first legislative approach outlined in the discussion paper enclosed with your October 27 letter (i.e., repeal of the Act) would obviously remove this impediment, our comments are limited to what we consider to be the most important aspect of the second approach, namely amendment of section 3 of the Act to remove the "unless and except" clause. Because Puget's service areas are located entirely within the state of Washington, a holding company structure adopted by Puget for diversification purposes should be eligible for an exemption under section 3(a) (1) or (2) of the Act. Consequently, amendment of section 3 to provide exemptions for certain holding companies with only one public utility subsidiary and holding companies created by companies that are presently exempt under section 3(a)(2) of the Act would not have an immediate impact on Puget's present or prospective future operations.

On the other hand, amendment of section 3 to remove the "unless and except" clause appears to be a prerequisite to Puget's diversification through a holding company structure. Puget views the "unless and except" clause as a substantial and unnecessary barrier to diversification through the holding company structure. Section 3 of the Act requires the SEC to exempt certain types of holding companies and their subsidiaries "unless and except insofar as it finds the exemption detrimental to the public interest or the interest of investors or consumers." The SEC may rely upon the "unless and except" clause to revoke a previously granted exemption. The risk and consequences of revocation of an exemption for a diversified electric utility company cannot be ignored.

For example, Puget in the past has been presented opportunities for diversification into businesses that are not functionally related to its electric utility business. However, the SEC has interpreted the policy statement in section 1(b)(4) of the Act and the "other business" clauses of section 11(b) (1) as permitting a holding company system to engage only in those businesses which are functionally related to its public utility business. For an exempt company, diversification into businesses that are not functionally related to its public utility business may be cause for revocation of the exemption on the basis of the "unless and except" clause. Revocation of the exemption would most likely result in the forced divestiture of those businesses which are not functionally related to the utility business, thereby defeating the very objective to be facilitated by adoption of the holding company structure.

Removal of the "unless and except" clause would relieve a strong chilling effect of the Act on certain diversification opportunities being considered by Puget. Such removal should not have an adverse effect on the Washington Utilities and Transportation Commission or on Puget's stockholders and ratepayers.

In summary, we applaud your concern over the financial plight of electric utility companies in today's regulatory environment and wish to encourage your efforts to remove federal statutory and regulatory barriers that inhibit the ability of utilities to improve their financial performance through diversification. Repeal or amendment of the Act in the manner described in your October 27 letter is certainly a step in the right direction.

If we can be of any further assistance in this regard, please do not hesitate to contact us.

Sincerely yours,

Neil L. McReynolds
Vice President
Corporate Relations

HAWAIIAN ELECTRIC COMPANY, INC.
Box 2750 Honolulu, Hawaii 96840

PETER C. LEWIS
VICE PRESIDENT ADMINISTRATION
AND SECRETARY

December 1, 1981

The Honorable Tom Corcoran
U. S. House of Representatives
1107 Longworth House Office Bldg.
Washington, D. C. 20515

Dear Representative Corcoran:

This is in response to your letter of October 27, 1981 to Carl Williams, former President of Hawaiian Electric Company.

Hawaiian Electric Company, Inc., is a holding company within the meaning of the Public Utility Holding Company Act of 1935 ("PUHCA"), but is exempt under Section 3(a) because the holding company and its utility subsidiaries are predominantly intrastate in character.

In such a situation, the regulation by the State Public Utilities Commission of the utility activities is sufficient to protect the interest of the ratepayers and the stockholders, in our opinion. In Hawaii, the State Public Utilities Commission also has sufficient jurisdiction in the area of diversification.

Therefore, an amendment of the PUHCA to permanently exempt each holding company and each subsidiary company thereof which is a public utility company (irrespective of the number of subsidiaries) and which are predominantly intrastate in character would eliminate unnecessary federal government regulation.

Sincerely,

Pete C. Lewis

CILCO
Central Illinois Light Company
300 LIBERTY ST. / PEORIA, ILL. 61602

R. Dean Westervelt
Senior Vice President

December 1, 1981

The Honorable Tom Corcoran
1107 Longworth House Office Building
Washington, D.C. 20515

Dear Congressman Corcoran:

Mr. Feltenstein has been out of the city and has asked me to reply to your letter of October 27.

It is my understanding that Senators D'Amato and Johnston introduced Public Utility Holding Company Act legislation, S.B. 1870, within the past two weeks.

We further understand that this proposed legislation would encompass the second legislative approach outlined in your letter. We are a part of a utility group that suggested this legislation, and we support this approach.

In our opinion, if legislation was passed to exempt holding companies, we believe that most single utility companies like CILCO would approach this with caution. Secondly, it would be necessary for the state PUCs to develop a series of definite rules and regulations to handle these situations fairly and equitably.

We certainly appreciate your interest in possibly removing Federal statutory and regulatory barriers that may inhibit single public utilities from diversifying.

Sincerely,

RDW:sdj

Houston
Industries
Incorporated

D. D. Jordan
President and Chief Executive Officer

November 30, 1981

The Honorable Tom Corcoran
U. S. House of Representatives
1107 Longworth House Office Bldg.
Washington, D.C. 20515

Dear Congressman Corcoran:

Thank you for your letter of October 27, 1981 regarding the impact on the utility industry of the Public Utility Holding Company Act of 1935. Although, as you noted in your letter, Houston Industries is an "exempt" holding company for purposes of the 1935 Act, it is very directly affected by the general financial health of the electric utility industry. Our principal operating subsidiary, Houston Lighting & Power Company, expects to spend an average of more than $1 billion a year throughout the 1980's for capital construction to meet the growing needs of our service area. At least two-thirds of this amount will have to be financed through external sources. Accordingly, the perception of the electric utility industry in the capital markets is a matter of major concern to us.

In response to your specific questions, it is our impression that the pyramiding schemes and other abuses that the 1935 Act was intended to correct are problems of the distant past. To our knowledge, there have not been any holding company structures with these undesirable characteristics for more than 30 years. The continuous reporting system established under the Securities Exchange Act of 1934, the registration system under the Securities Act of 1933 and the enforcement powers vested in the Securities and Exchange Commission all provide ample protection of the interests of stockholders of public utility holding companies. Similarly, the plenary jurisdiction of the state commissions over transactions between regulated utilities and their non-utility affiliates provides ample protection of the interests of ratepayers. From our perspective, the 1935 Act represents a duplicitous and unnecessary layer of regulation upon an important segment of our industry. It also discourages the rest of us from attempts at diversification that could be beneficial to stockholders and ratepayers alike. We believe, therefore, that outright repeal of the 1935 Act would be very much in the public interest.

For the most part, the consuming public in our service area is not aware of a federal role in the regulation of local electric utilities, at least insofar as the 1935 Act is concerned. To the extent that the public perceives any activity at the federal level, it is generally that of the Federal Energy Regulatory Commission under different and unrelated legislation. We understand that the SEC's Division of Corporate Regulation, which administers the 1935 Act, currently has a professional staff of less than 10 individuals. From the point of view of consumers, this hardly constitutes a "federal role" in the regulation of local utilities. Thus, repeal of the 1935 Act would not, in our judgment, result in any diminution in the public's confidence in either state or federal regulation.

You have asked to what extent, if any, repeal of the 1935 Act or removal of the "unless and except" clause would lead to utility diversification. We at Houston Industries certainly do not foresee any rush to expand into other businesses, particularly in view of the demands currently being placed upon our financial and managerial resources. It is possible, however, that opportunities would present themselves which have heretofore passed us by because of the 1935 Act. If such an opportunity should arise which (a) holds out the prospect of materially improving the market price for our common stock (from which our ratepayers would benefit through reduced costs for construction financing) and (b) involves a situation that would not dilute or divert our present management from its responsibilities to utility operations, then we would owe an obligation to both our stockholders and our ratepayers to take advantage of that opportunity.

On behalf of Houston Industries Incorporated, I want to thank you for allowing us to express our views on this matter. Please do not hesitate to contact me if I may be of further assistance.

Sincerely yours,

AMERICAN ELECTRIC POWER *Company, Inc.*

AEP

180 East Broad Street, Columbus, Ohio 43215
(614) 223-1000

W. S. WHITE, JR.
Chairman of the Board
and
Chief Executive Officer
(614) 223-1500

November 30, 1981

Honorable Tom Corcoran
U.S. House of Representatives
1107 Longworth House Office Building
Washington, D. C. 20515

Dear Congressman Corcoran:

I am responding on behalf of the American Electric Power System to your letter of October 27th relating to proposed amendments to the Public Utility Holding Company Act of 1935 (the "1935 Act").

American Electric Power Company, Inc. and its eight electric utility subsidiaries constitute a registered holding company subject to regulation under the 1935 Act. The service area of the AEP electric utility subsidiaries covers portions of the states of Ohio, Indiana, Michigan, Virginia, West Virginia, Kentucky and Tennessee. The AEP utilities consist of Appalachian Power Company, Columbus and Southern Ohio Electric Co., Indiana & Michigan Electric Company, Kentucky Power Company, Kingsport Power Company, Michigan Power Company, Ohio Power Company and Wheeling Electric Company. These companies provide electric service to nearly 2,500,000 customers.

Your letter put forth for discussion two legislative approaches. The first concerned possible repeal of the 1935 Act and the second proposed broadened exemptions for holding companies which are exempt from the provisions of the 1935 Act. Since AEP is a regulated public utility system and is not exempt from the 1935 Act, I would propose to restrict my comments to the first legislative approach.

Question 1 under this approach inquired as to whether utility companies continue to present the problems of size and structural complexity that the 1935 Act was intended to correct.

I believe this goal of the 1935 Act has been long achieved for all of the remaining registered holding company systems. For example, the AEP System has a simple corporate structure consisting of a non-operating holding company, eight directly owned operating utilities which, in certain instances, have coal mining subsidiaries of their own, and a service corporation which is also directly owned by the parent holding company and which renders at cost engineering, accounting, financing and other services to the operating utilities.

Question 2 concerned the extent to which federal and state laws would protect the interests of stockholders and ratepayers if the 1935 Act were repealed. It is clear that since 1935 the Federal Power Commission (now the Federal Energy Regulatory Commission) and the state commissions have assumed much greater strength and power and have largely occupied the void that the 1935 Act was intended to fill. Moreover, the Securities Act of 1933 and the Securities Exchange Act of 1934 have expanded to a scope not envisioned at their enactment so as to provide adequate protection to shareholders. Nonetheless, it is my belief that complete repeal of the 1935 Act is neither necessary nor appropriate. The 1935 Act does serve to regulate the holding company system as a whole, rather than as disparate entities, particularly in the important area of intercompany transactions. Therefore, it would seem more appropriate at this time simply to modernize certain of the provisions of the 1935 Act so as to eliminate unnecessary duplication of regulatory burdens. Such actions could productively be taken in the area of financing. In addition, the 1935 Act could be amended to allow regulated companies the same opportunity to diversify into non-utility functions as is afforded utilities not subject to the 1935 Act.

Questions 3 and 4, respectively, sought to determine whether repeal of the 1935 Act would result in conflicting state regulation and whether public confidence in the state commissions is sufficient to reduce the federal role in regulation of local utilities. Under such circumstances, the state commissions should, in my opinion, continue to exert regulation over a local utility without serious conflicts arising. However, it should be recognized that some conflicts might result in commission review of transactions with non-regulated and out-of-state subsidiaries. In addition, the public interest is sufficiently protected on the state level so as to permit the reduction of regulation on the federal level. The major focus of the public has been centered on rate regulation -- an area in which the 1935 Act is not involved. Consequently, the public confidence should not be affected if the 1935 Act were repealed or amended. This should particularly be the case if amendment of the 1935 Act is undertaken in the areas of financing and diversification since these subjects have not generally been of significant interest to the public.

Finally, Question 5 asked the impact that repeal of the 1935 Act would have on the state commissions, the utilities, stockholders, and ratepayers. I believe the state commissions and stockholders benefit from the overall review of the holding company system exercised by the Securities and Exchange Commission under the 1935 Act. Such review is particularly useful in the area of intercompany and affiliated transactions. Consequently, repeal of the 1935 Act would not result in a clearly favorable impact. However, if the 1935 Act were simply amended to eliminate unnecessary regulatory burdens in financing and to permit diversification, this action should be deemed to be clearly beneficial to all parties. In my opinion, diversification would most likely develop in fields allied or associated with the utility business such as fuel and transportation. The more efficient and profitable use of such assets already in place for utility purposes should serve to benefit both ratepayers and stockholders. However, it is unrealistic to expect the relatively small scope of business activity represented by diversification to cure the basic and fundamental financial problems of the utility industry.

I appreciate your concern about the utility industry and wish to thank you for the opportunity to respond to your questions.

Very truly yours,

W. S. White, Jr.

lm
Express Mail

New England Electric

Guy W. Nichols
Chairman, President and
Chief Executive Officer

New England Electric System
25 Research Drive
Westborough, Massachusetts 01581
Tel. (617) 366-9011 TWX 710-390-0732
Cable: NEELECSYS WTBO

November 30, 1981

Honorable Tom Corcoran
U.S. House of Representatives
1107 Longworth HOB
Washington, D.C. 20515

Dear Congressman Corcoran:

I am writing on behalf of New England Electric System to respond to your questions regarding proposals to amend the Public Utility Holding Company Act of 1935.

New England Electric System (NEES) is an electric utility holding company system which, through its three distribution subsidiaries, delivers electricity to communities in Massachusetts, New Hampshire and Rhode Island. New England Power Company (NEP), NEES's generation and transmission subsidiary, sells power at wholesale to the NEES system distribution companies, and also makes interstate wholesale sales to other New England electric utilities.

The questions appended to your letter ask that we consider two approaches to amending the Public Utility Holding Company Act; the first would repeal the Act, and the second would broaden the exemptive categories and remove SEC administrative control over exempt holding companies. I would like to confine my response at this time to the questions which pertain to total repeal. As noted above, NEES is engaged in the public utility business through more than one operating subsidiary. Given our present corporate structure, we would not be eligible for exempt status as proposed in Approach No. 2.

Approach One: Repeal the PUHCA with provisions stating that such repeal would not affect any PUHCA proceeding previously commenced.

Question 1: To what extent, if any, do utility companies continue to present the problems of size and structural complexity the Act was intended to correct? Please specify.

Response:

The Congress that enacted PUHCA in 1935 faced the task of correcting the abusive practices of giant holding companies which controlled, in many cases, as many as 100 or more utility and non-utility businesses reaching into all geographic areas of the United States. The complexities of these structures enabled a small group of stockholders at the top of these elaborate pyramids to mask many forms of abusive practices including excessive encumbrances of utility assets, undercapitalization of securities issuances, watering the value of outstanding shares, and imposition of excessive charges on consumers through "sweetheart contracts" for the provision of management services by the holding companies to the utility subsidiaries.

These abuses, described in the Congressional findings in section 1 of the Act, compelled Congress to require the SEC to dismantle each of these systems, leaving intact a holding company system comprised only of those businesses necessary and incidental to the operation of a single geographically-integrated public utility system. To prevent recurrence of these abuses, Congress also gave the SEC comprehensive authority to review and approve or disapprove most of the financing, investment and affiliate transactions of a holding company system. The severity of these controls reflects the then-prevailing assumption that only constant federal scrutiny could prevent the natural tendency of holding company management to recreate the abuses of the past.

By 1952, the Act's mandate to the SEC to dismantle the holding company systems was largely accomplished through lengthy and complicated divestiture proceedings. Today, a utility holding company is a simple management device used to organize the business of a limited number of operating utility companies and, in some cases, diversified ventures that contribute a relatively small portion of the system's annual earnings. Nevertheless, the Act's pervasive system of regulatory controls over securities issuances and investment decisions continues to apply to a small number of registered holding company systems whose management must guide the course of corporate business and financing to accommodate regulatory delays and standards for business decision making set by the SEC.

In association with seven other registered electric utility holding companies, NEES supports a scheme for amending PUHCA that rests on the assumption that today's holding company management can be trusted both to protect the interests of its investors and to fulfill its service obligations to its customers. That scheme is set out in S. 1869, which was introduced on November 19 by Senators D'Amato and Johnston. The SEC's command control authority over securities issuances, which subjects basic corporate decision making to the overriding judgment of the SEC, would be changed to provide a fail-safe mechanism by which the securities issuances would be automatically effective unless the SEC, within a specific review period, determines that the issuance involves an unsound financial practice. Comparable to the case of securities issuances, the SEC would retain a fail-safe authority to correct an improvident diversification decision: the SEC would retain authority to seek divestiture of a non-utility business, based on factual determinations that the business was material to the holding company's business, and its retention would be detrimental to the interests of investors or consumers. We believe these amendments represent a sensible and entirely justified intermediate step to repeal.

It is clear that circumstances have changed dramatically and irreversibly from those which characterized the utility industry in the first part of this century. Indeed, the Congress may well conclude that the array of existing state and federal rate regulatory powers, coupled with the evolution of professional standards in the accounting profession and the high degree of investor protection achieved under the nation's securities laws, more than suffice to safeguard the public interest. PUHCA may now be entirely anachronistic.

Question 2: To what extent would federal and state law adequately protect the interests of stockholders and ratepayers were PUHCA to be repealed?

Response:

The Federal Power Act, enacted at the same time as PUHCA, empowers the Federal Energy Regulatory Commission (FERC) to regulate the transmission of electric energy in interstate commerce, as well as the sale of electric energy at wholesale (i.e. for resale), in interstate commerce. The same Act gives FERC jurisdiction over all facilities for such transmission and sale. NEP, as a wholesale generation and transmission company, is therefore subject to comprehensive regulation by FERC with regard to essentially all aspects of its business, including the allocation of costs between utility and non-utility businesses for purposes of cost-based ratemaking. The Massachusetts, Rhode Island and New Hampshire Commissions regulate the rates of NEES distribution companies within their respective jurisdictions. Repeal of the PUHCA will not affect the authority of FERC and the state commissions to protect the interests of consumers in executing their respective ratemaking responsibilities.

Moreover, it should be emphasized that repeal of PUHCA will not leave the assets of utility companies vulnerable to ill-conceived disposition or to excessive encumbrances arising from issuances of securities or other assumptions of liability. Under sections 203 and 204 of the Federal Power Act, the FERC has authority to review and approve any significant disposition of utility assets, as well as the securities issuances and assumptions of liability by utilities subject to the FERC's ratemaking authority. The FERC must review and approve the disposition of utility assets unless the disposition is subject to review by the SEC under PUHCA. And, the FERC must review and approve securities issuances and assumptions of liability by a jurisdictional company such as NEP, unless that financing activity is subject to review by the SEC under PUHCA, or by a state agency granted authority to regulate such issuances by utilities organized and operating within that state. In the case of NEP and the other NEES operating companies, issuances, as well as acquisitions, of securities are subject to approval by state commissions in their respective states of organization and operation.

In addition, NEES companies are subject to the rules governing securities registration, trading and investor disclosure under the Securities Act of 1933 and the Securities Exchange Act of 1934. Thus, NEES' investors enjoy the same substantial protections afforded investors in all other publicly-traded corporation.

Question 3: Would the repeal of PUHCA result in conflicting state regulation? To what extent, if any, would this affect the public interest?

Response:

As pointed out above, NEES operating companies are subject to regulation of their rates and financings by FERC and/or state commissions. This regulation would survive repeal of PUHCA. Nor does there appear to be any prospect of conflict developing between the states as a result of such repeal. FERC regulation, of course, preempts state regulation of matters relating to interstate transmission and wholesale sale of power and therefore precludes any conflict with regard to such matters.

Question 4: Does the public have enough confidence in their state PUCs to reduce the federal role in regulation of local utilities?

Response:

The combined state and federal authority to regulate the rates charged and securities issued by public utilities, to enforce tariffs and service obligations and safeguard the encumbrance of utility assets--all powers which would continue in effect even if PUHCA were repealed--are quite sufficient to protect the public interest in maintaining adequate and reliable utility operations. Whether the public has confidence that this is so is not known. That it is so we believe can be demonstrated to the satisfaction of the Congress should the opportunity be presented.

Question 5: In your opinion, how would repeal affect your state PUC, the utilities, stockholders and ratepayers? In particular, to what extent, if any, would repeal of PUHCA lead to diversification?

Response:

The repeal of PUHCA would free utility management from unnecessary and largely duplicative regulatory burdens. To the extent that utility management, left to its own business judgment, were to conclude that it could usefully and profitable engage in non-utility ventures, one can expect that the removal of constraints contained in PUHCA would lead to greater diversification than might otherwise occur. However, in our opinion, utility shareholders and ratepayers are likely to be better off than under the existing system of controls. Diversification provides a meaningful opportunity to improve and tone management strength, to buttress investor interest in utility stocks and to improve the financial circumstances of the electric utility industry. Let me hasten to add that diversification is not a "solution" to the financial crisis which confronts the electric utility industry. Only responsible administration of rate regulatory powers and prudent business planning on the part of electric utilities will extract the industry from its current difficulties. Diversification, however, provides an important opportunity to improve financial conditions.

Let me conclude by expressing my appreciation for your interest in this matter. I would be pleased to discuss these issues in greater detail should you desire.

Sincerely

BALTIMORE
GAS AND
ELECTRIC

CHARLES CENTER • P. O. BOX 1475 • BALTIMORE, MARYLAND 21203

GEORGE V. MCGOWAN
PRESIDENT

November 30, 1981 4

Hon. Tom Corcoran
1107 Longworth House Office Bldg.
Washington, D.C. 20515

Re: Public Utility Holding Company Act

Dear Congressman Corcoran:

Your letter of October 27, relative to alternative approaches to changing the Public Utility Holding Company Act of 1935, is quite timely, since, as you know, a number of utilities are now actively considering this question. Our Company is participating in a group of utilities which is preparing legislation to amend Section 3 of the Act (your "approach two"). In responding to your questionnaire, I would like to briefly state this Company's position in support of the proposed amendments to Section 3 of the Act.

First, let me say that we believe a strong case could be made for outright repeal of the Act. The pyramiding schemes and securities manipulations which led to passage of the 1935 Act were corrected years, even decades, ago. Unlike the situation in 1935, today utilities are subject to extensive State regulation, SEC regulation of utility securities, and antitrust laws. In our opinion, this present-day panoply of State and Federal regulation fully protects ratepayers, stockholders and the public and obviates the need for the Act. The public knows about and has confidence in the State PUC, whereas it probably knows nothing about the SEC, at least insofar as utilities and PUHCA are concerned. We certainly perceive the public as having a strong preference for utilities being regulated at the State level rather than at the Federal level and believe that the public would view, and support, repeal of the Act as removing a layer of remote, unnecessary Federal regulation.

However, to us and our utility group the repeal approach just seems to be politically impractical, particularly in an election year. Congress is already involved in a number of major national issues. Outright repeal of the Act would become a significant, perhaps controversial, issue, and there will always be some resistence to repealing an entire Act irrespective of how outmoded it has become in the 46 years since its enactment. Repeal of the entire Act also would obviously take much longer to enact than would merely amending one section. For these reasons, we have concluded that the amendment approach is more feasible and should be pursued.

The three proposed amendments, as set out in your questionnaire, would remove possible obstacles in Section 3 to diversification and, thus, would predictably lead to some limited diversification by some utilities. We firmly believe that these amendments and any resulting diversification would be in the public interest. It is well known that the utility industry has had serious financial problems for the last ten years, as evidenced by their common stocks selling below book value, declining coverages of interest expenses, lowered bond ratings, and severe difficulty in raising capital on reasonable terms. Although BG&E's allowed rate of return during this period has not been adequate, we have not even been able to earn the allowed return due to inflation, attrition, and regulation. Thus, we view diversification into unregulated non-utility businesses as a possible means to make our stocks and bonds more attractive in the financial marketplace. This would lower the cost of capital to our ratepayers, benefit our stockholders, and improve our competitive financial standing. We appreciate your interest in this subject and your determination to remove Federal barriers to improving the financial condition of utilities. We urge you to support the three proposed amendments to PUHCA as an effective means of obtaining this objective.

We trust that these general comments will be of some assistance to you in considering the subject of utility diversification and any PUHCA legislation that may be introduced. We would, of course, be pleased to provide any other information you may need.

Sincerely yours,

G. V. McGowan

CP&L
Carolina Power & Light Company
P. O. Box 1551 • Raleigh, N. C. 27602
(919) 836-6382

SHERWOOD H. SMITH, JR.
Chairman/President

November 30, 1981

The Honorable Tom Corcoran
United States House of Representatives
1107 Longworth House Office Building
Washington DC 20515

Dear Congressman Corcoran:

Thank you for your letter of October 27, 1981, concerning the relationship between electric utility diversification and the Public Utility Holding Company Act of 1935. This is in response to the questionnaire you enclosed.

We are grateful for your recognition of the very difficult financial condition of electric utilities, and your interest in providing ways in which electric utilities can become financially stronger. Such would benefit our consumers, as well, by helping to ensure adequate electric power in the future, by increasing the prospect for our nation to enjoy continuing progress in providing good jobs and an improved standard of living for all citizens. As you have evidently surmised, the potential benefits of diversification simply will not be feasible in a number of instances if the Holding Company Act remains in its present form as a deterrent.

APPROACH ONE addressed in your questionnaire encompasses legislative action that is much broader than we can envision as being needed by this company, since we are not subject to the Holding Company Act. Therefore, our company simply is not in a position now from which it is feasible to seek to measure the likely effects of APPROACH ONE.

However, APPROACH TWO does address a situation which CP&L might find applicable. We would be inclined to support the passage of legislation designed to accomplish the three areas outlined in APPROACH TWO.

Some utilities believe that the existing potential for diversification by them appears to be quite good. For a number of reasons, our company does not consider diversification as an immediate likelihood, but we are well aware that future events may make diversification feasible for us, and we expect to explore, as a continuing company activity, the diversification opportunities. There is no question but that the Holding Company Act, unless amended, would diminish our interest in investigating and pursuing such opportunities.

To specifically address Question 1 under APPROACH TWO, the exemption of holding companies having only one public utility subsidiary (whose operations would be confined to the state of incorporation and contiguous states) appears to be by far the preferred structure for diversification from our viewpoint as an independent operating company. In that regard, eliminating the "unless and except" clause is essential. We would not expect to pursue diversification through a separate company if becoming subject to the Holding Company Act were to be the result. One reason is that we would constantly wonder whether, and when, we might have to sell, on a distress-sale basis, the non-utility operation. In addition, the potential of having to meet the additional regulatory requirements of a non-exempt company would clearly affect the feasibility of diversification. Thus, our answer to your first question under APPROACH TWO is that, while amending the Act as suggested would not automatically create opportunities for sound diversification, the failure to amend it would clearly inhibit the entry into sound diversification programs which might be feasible presently for some utilities, and which we hope will become feasible later for us.

As for Question 2, the proposed amendments should be received well by the parties you list, especially the utilities and their shareholders. State commissions and rate payers probably would approve provided it did not appear that assets needed and available for utility service might be diverted into other ventures and thus jeopardize future service. Sound diversification, conducted through a separate corporate structure such as implied by APPROACH TWO should be acceptable and could lead to an improved financial standing for many electric utilities. Such added financial strength should be welcomed by all four groups and should enable utilities to raise capital at lower costs.

Sincerely yours,

Sherwood H. Smith Jr

Sherwood H. Smith, Jr.

SHSjr/lac

National Fuel

Louis R. Reif
President and
Chief Executive Officer

November 23, 1981 .

The Honorable Tom Corcoran
Representative 15th Illinois District
205 North Lake Street
Aurora, Illinois 60506

Re: Public Utility Holding Company Act

Dear Tom:

As you know we have been working with the two other gas companies in the nation still subject to the Public Utility Holding Company Act. National Fuel Gas Company joins in the views expressed by Jack Tankersly on behalf of Consolidated, Columbia and National Fuel in his recent letter to you. In addition to the points expressed therein, National Fuel would like to emphasize the common consensus that the Public Utility Holding Company Act of 1935 is obsolete and anachronistic. The simplest solution to relieving the American utility industry of this impediment and relieving the American taxpayer of the cost of administering this burden is the repeal of the Holding Company Act.

We understand that there are some people who may express the feeling that parts of the Holding Company Act should be preserved and that other parts should be modified in order to achieve some particular goals. We suggest that the most efficient approach to achieve those specific objectives is to repeal the Public Utility Holding Company Act of 1935 and then to pass specific legislation designed to deal with today's problems. Dealing with a variety of modifications and amendments is needlessly time consuming and complicated and will leave us merely with a patched up version of an obsolete law.

Very truly yours,

NATIONAL FUEL GAS COMPANY/10 LAFAYETTE SQUARE/BUFFALO NY 14203

GENERAL
PUBLIC
UTILITIES
CORPORATION

William G. Kuhns
Chairman
100 Interpace Parkway
Parsippany, New Jersey 07054
(201) 263-6500

November 25, 1981

The Honorable Tom Corcoran
Congress of the United States
House of Representatives
Washington, D.C. 20515

Dear Mr. Corcoran:

I acknowledge receipt of your letter dated October 27, 1981 seeking my comments on possible repeal or amendment of the Public Utility Holding Company Act. As the owner of Three Mile Island nuclear generating station, we continue to be preoccupied with matters relating to that station, its regulatory treatment and the critical cleanup funding program, to an extent that has caused us to play a rather passive role in considering possible changes in the holding company act. I hope you will understand that this TMI preoccupation continues to deprive me of any ability to give you a thoughtful and detailed consideration to the questions you have raised.

Certainly it is clear that circumstances have changed dramatically from those which led to the enactment of the Public Utility Holding Company Act. It is indeed appropriate that changes in this federal law be considered.

Sincerely,

WGK:mn

MIDDLE SOUTH UTILITIES, INC/BOX 61005/NEW ORLEANS, LA 70161/(504) 529-5262

FLOYD W. LEWIS
CHAIRMAN/PRESIDENT

November 27, 1981

11/30/81 F.J. [illegible]

Honorable Tom Corcoran
United States House of Representatives
1107 Longworth House Office Building
Washington, D.C. 20515

Dear Congressman Corcoran:

Middle South Utilities is pleased to respond to your request for comments on the repeal or modification of the Public Utility Holding Company Act of 1935. The Middle South Utilities System is a registered holding company system subject to regulation under the PUHCA, of which there are only a small number. We feel strongly that the primary purpose of the PUHCA — the corporate simplification and geographical integration of public utility holding company systems — has been accomplished. Because of this simplification and integration, because of the maturation of state and local regulation over the last 46 years, and because of Federal securities and utility regulatory legislation that duplicate many provisions of the Act, there is no longer justification for continuing this extra layer of bureaucratic regulation and to do so could be considered wasteful.

These and other justifications for total repeal of the PUHCA are further discussed in the attachment, "Repeal of the Public Utility Holding Company Act of 1935." We have reviewed the two legislative approaches included in the attachment to your letter and we favor Approach One, the repeal option.

Our responses to your questions are as follows:

Questions on Approach One (Repeal)

Question 1: To what extent, if any, do utility companies continue to present the problems of size and structural complexity the Act was intended to correct?

Response: The PUHCA had, by the early 1950's, completely achieved its objective of dramatically reducing the size and structural complexity of holding company systems. There are no more geographically dispersed holding company systems but rather all of today's holding company systems are operated as geographically integrated public utility systems. A large number of the Fortune 500 industrials typically have many more subsidiaries than the average utility holding company system.

Question 2: To what extent would federal and state law adequately protect the interests of stockholders and ratepayers were PUHCA to be repealed?

Response: The protection of investors was one of the primary reasons that the PUHCA was enacted. It is this same protection of investors' interests that we feel is one of the most compelling reasons for repealing the Act today. The holding company systems still subject to the Act must carry an extra layer of regulation which is not applicable to another utility of equal or greater size with comparable multi-state service area which is organized as a single corporation. All of the protections afforded stockholders in such a single corporation would be afforded the stockholders of a utility holding company after repeal of PUHCA and, in addition, freedom to pursue economic opportunities to improve stockholder returns would be enhanced.

After repeal of the PUHCA, the stockholders of a holding company would still enjoy the protection of the 1933 Securities Act, the 1934 Exchange Act, and, for utilities, the Federal Power Act and Natural Gas Act.

The PUHCA is also unnecessary for the protection of ratepayers because of the maturation of state and local regulation in the past 46 years. For instance, Mississippi did not even have a public service commission until the mid-1950's. But now that state and all of the other rate regulatory authorities have the power to address the reasonableness of costs incurred in affiliate transactions or the allocation of costs between utility and non-utility businesses for purposes of ratemaking.

After repeal of the PUHCA, the state regulatory agencies will continue to have control over the lifeblood of the companies -- their utility rates.

Question 3: Would the repeal of PUHCA result in conflicting state regulation? To what extent, if any, would this affect the public interest?

Response: We do not believe that repeal of PUHCA will result in conflicting state regulation.

Question 4: Does the public have enough confidence in their state PUCs to reduce the federal role in regulation of local utilities?

Response: We believe that very few members of the public have any concept of the regulation of holding companies by the SEC under the PUHCA. The majority of the public today looks to the state PUC's for supervision of financing, intercompany transactions, and other functions duplicated by the SEC under the PUHCA. There appears to be no lack of confidence in the state commissions in these areas.

Question 5: In your opinion, how would repeal affect your state PUC, the utilities, stockholders, and ratepayers? In particular, to what extent, if any, would repeal of PUHCA lead to diversification?

Response: We believe that there will be no adverse effects from repeal of the PUHCA. On the contrary, we feel an unnecessary and costly regulatory burden will be removed with the resultant savings benefiting all of the mentioned parties.

As for diversification, we believe repeal of the PUHCA will permit but will not necessarily lead to diversification. It is only the existence of more attractive investments that will encourage diversification.

Questions on Approach Two (Modification)

Question 1: To what extent, if any, would this approach lead to utility diversification?

Response: This proposed modification of the PUHCA would not exempt the Middle South Utilities System and, therefore, we would find ourselves still subject to the Act's restraints on diversification. To enjoy the same regulatory status as most other utility companies, we would have to change our form of organization, merging all of our operating companies into one utility.

For those companies which are not now holding companies, a one utility holding company exemption would facilitate diversification using the holding company model. We reiterate our comment in our response to Question 5 above that permitting diversification is only one condition. Of a greater necessity is the existence of more attractive investment opportunities.

Question 2: In your opinion, how would enactment affect your state PUC, the utilities, stockholders, and ratepayers? In particular, to what extent, if any, would enactment lead to diversification?

Response: While we would prefer this modification to the status quo, we could be harmed if the legislation continued to single us and other non-exempt holding companies for an extra layer of regulation while other utilities, similar in all other respects to us, were released.

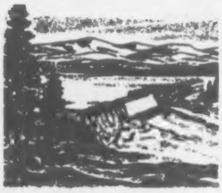
Our previous comments on diversification apply here also.

We would like to thank you for your interest in this issue. Your consideration of repeal of the PUHCA is very encouraging to us. While "deregulation" is desirable, we submit that "delegislation" with respect to laws and agencies that are no longer needed is preferable. We would be pleased to discuss these matters further with you.

Sincerely,

FWL:js
Enc.

WWP 3111 REV. 8-73



THE WASHINGTON WATER POWER COMPANY

P.O. BOX 3727 • SPOKANE, WASHINGTON 99220 • (5[illegible]) 489-0500

WENDELL J. SATRE
PRESIDENT
CHAIRMAN OF THE BOARD

November 25, 1981

Honorable Tom Corcoran
Representative in Congress
1107 Longworth House Office Building
Washington, D. C. 20515

Dear Mr. Corcoran:

In answer to your letter of October 27, 1981, with reference to the Holding Company Act, I must first state emphatically that in my opinion, the Public Utility Holding Company Act of 1935 has long outlived its usefulness, is an unnecessary and overlapping layer of regulation and should be repealed.

I would therefore support "Approach One" and answer your questions as follows:

Question 1. In my opinion the utility companies do not continue to present the problems of size and structural complexity the Act was intended to correct. The utility industry is much less concentrated than many other industries, it is subject to the antitrust laws and to the 1933 and 1934 Securities and Exchange Acts as are other industries. In addition, utilities are regulated as to accounting and in certain instances as to issuance of securities by the Federal Energy Regulatory Commission under the Federal Power Act.

Question 2. In my opinion the Federal Power Act, the Securities and Exchange Acts, the federal antitrust laws and the state regulatory laws adequately protect the interests of stockholders and ratepayers.

Question 3. The Public Utility Holding Company Act now regulates only a segment of the utility industry and if repealed would have little effect on the regulation by the states of a great majority of utility companies. To the extent there may appear to be the possibility of a conflict between states, it has never developed into a major problem.

Question 4. I seriously doubt that the public has any concept of the overlapping regulation created by the Public Utility Holding Company Act, the Federal Power Act, the Securities and Exchange Acts and state regulation. As mentioned above, the Holding Company Act regulates only a segment of the industry. Someone dedicated to the concept of the Act perhaps could arouse a public response to a proposed repeal, but such a response would not be based on the facts objectively presented.

Question 5. There are no holding companies presently operating in the states in which this Company operates and therefore there would be no immediate effect on the state PUC's, utilities, stockholders and ratepayers. It is entirely speculative whether repeal of the Act would result in increased diversification of the industry, particularly if by diversification is meant the entry into completely unrelated businesses. The principal benefit from repeal of the Holding Company Act would be to allow Companies such as ours to use more flexibility in methods of financing, particularly in the financing of new generating plants. In addition to complying with federal securities laws, our Company must receive approval from both the Washington and the Idaho State Commissions for any type of long-term financing it may do. The limitations of the Holding Company Act on top of these restrictions is arbitrary and is a very good example of over-regulation.

With respect to "Approach Two", the first problem that arises is the continuation of the present ambiguous language in the Holding Company Act which refers to the "state of incorporation and contiguous states." This Company is incorporated in the State of Washington and has an integrated system which operates in the eastern part of Washington, the northern panhandle of Idaho and the western part of Montana. It is not possible to get a firm legal opinion as to whether the permitted exemption under the Act includes such a condition or whether each of the states must adjoin the state of incorporation. There is no rational reason for this distinction and if Approach Two is used, it is hoped that this language will be clarified.

In answer to your questions related to "Approach Two", I would hesitate to speculate as to whether the enactment of these types of amendments to the Holding Company Act would result in increased diversification. We have made no study of a plan to create a holding company which would own the stock of the present utility company. I am aware that other companies have made such studies and would defer to them.

Sincerely,

W. J. Satre

Wendell J. Satre
President

S.bw

PACIFIC GAS AND ELECTRIC COMPANY
PG&E 77 BEALE STREET • SAN FRANCISCO, CALIFORNIA 94106 • (415) 781-4211

JOHN E. KOEHN
VICE PRESIDENT-GOVERNMENTAL RELATIONS

November 25, 1981

Honorable Tom Corcoran
House of Representatives
1107 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Corcoran:

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Frederick W. Mielke, Jr., has asked that I respond to your letter of October 27, 1981, soliciting the views of Pacific Gas and Electric on proposals to amend the Public Utility Holding Company Act of 1935.

Your concern about the financial difficulties and regulatory constraints which confront the utility business is quite appropriate. For a number of years, investor-owned gas and electric utilities across the country have been trying without much success to secure reforms of various laws and regulations which impede the ability of utilities to conduct their business in an efficient manner. Inasmuch as the Public Utility Holding Company Act of 1935 is perhaps foremost among those federal laws which constrain the manner in which utilities may organize their business activities, I welcome the opportunity to provide you with our views on the benefits which would flow from modifying that statute.

I have attached detailed comments on the two alternatives outlined in your letter. In reviewing these and other responses you may receive, I urge you to consider the subject of diversification in the context of the overall financial condition of the utility industry, and to bear in mind that unless financial health is restored, the ability of the utilities to provide adequate service will be jeopardized.

Once again, PGandE appreciates the opportunity to comment on this issue. If we can further assist you in any way in implementing the reforms outlined in the attached, please let me know.

Sincerely,

John E Koehn

JEK:ta
attachment
cc F. W. Mielke, Jr.

COMMENTS ON PROPOSED REFORMS OF THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

On October 27, 1981, Rep. Thomas Corcoran requested the Pacific Gas and Electric Company's ("PGandE" or "Company") views on two alternative reforms of the Public Utility Holding Act of 1935 ('35 Act). The following comments respond to that request.

Overview

As has been made abundantly clear in the recent Congressional hearing on utility "least-cost strategies," the electric utility industry is generally in unhealthy financial condition. Continuing inflation, rising fuel costs, unprecedented capital costs for new generation facilities, and delays and failures in adequate rate relief are just a few of the factors which have resulted in earned rates of return for utilities being below levels authorized. In turn, the inability of utilities to earn a reasonable rate of return has sapped their financial strength, heightened investor perception of the risks associated with utility securities, and resulted in low market to book ratios and falling utility bond ratings.

PGandE's financial situation is representative of most of the other major gas and electric utilities. Over the last ten years the rates set by the CPUC have resulted in customers paying about $1.4 billion less than it has cost PGandE to provide them with service. In 1981 alone the Company estimates that the shortfall between rates and the amount needed to earn the rate of return of CPUC has previously found reasonable will amount to $311 million. As a result, the estimated earned rate of return for 1981 will only be 8.2 percent - not even close to the 14.1 percent the CPUC has authorized.

The extreme disparity in earned versus authorized rates of return has, of course, been borne by Company shareholders. The securities markets have properly perceived this to be the case, as PGandE's present low market value to book value ratio of approximately 73 percent confirms. With debt costs at record levels and each additional equity issue causing a further dilution of current shareholder's interests, PGandE faces the same hobson's choices which are familiar to most utilities across the country. Unless broad relief is forthcoming PGandE and other utilities will have difficult choices to make which will ultimately affect the level and quality of utility service in the future.

Given the variety of factors which have caused the present dilemma, it is clear that no single action will solve the utility financial problems. For that reason, PGandE does not view the "diversification option" as a panacea. Without a strong general economy, a stable monetary system, and timely and adequate rate relief, financial problems will persist for PGandE and the utility industry as a whole.

Despite the fact that diversification is thus not being viewed as critical to the recovery of utility financial health, PGandE does perceive that under the right circumstances diversification activities can contribute to that recovery. Properly utilized, diversification can both provide new revenue streams and stabilize overall profits. Moreover, diversification can and should be justified not only because any resulting profits will allow investors to realize a full market return on their utility assets, but also because it results in the production of additional goods and services from existing but underutilized assets. In today's shrinking global resource base such underutilization should not be so easily countenanced.

Despite the fact that utilities like PGandE believe that there may be significant opportunities and benefits, both to its shareholders and indirectly to its ratepayers, which would result from diversification in business operations, to date few utilities have taken this course of action. A primary reason for the lack of diversification is that although the utility shareholders would likely bear the risk of failure in these endeavors, it is not clear that those shareholders would also stand to realize any benefits. This perceived disparity in treatment is in part a regulatory problem and in part an organizational or structural problem. More simply put, due in large part to the '35 Act there is currently no acceptable structural mechanism by which utility corporations which choose to devote shareholders assets into non-utility investments can be assured that the returns resulting will be insulated from the reach of utility regulatory bodies.

Approach One - Repeal of PUHCA

As an independent operating combination electric and gas utility company PGandE is not currently required to be registered under the '35 Act. 1/ To the extent that PGandE

1/ PGandE has no electric utility subsidiaries and none of its gas company subsidiaries sell natural gas at retail.

established any jurisdictional gas or electric subsidiaries, it would anticipate that such activities would qualify for exemption under various existing statutory provisions and Securities and Exchange Commission (SEC) implementing rules and regulations (e.g., section 3(a), rules 2, 7, 14, 15, 16).

The fact that PGandE currently is not subject to the '35 Act [2] is a reflection of a conscious decision by PGandE to avoid becoming subject to what the Company construes to be inappropriate and often duplicative restrictions contained in the Act. [3] From PGandE's perspective repeal of the '35 Act would thus not directly relieve it of any regulatory burdens. It would, however, clearly remove a primary obstruction which prevents PGandE from creating a parent holding company and thus diversifying through insulated subsidiaries. For that reason the Company would endorse repeal of an act which has long since served its purpose.

That the principal mission to be served by the '35 Act has largely been accomplished can hardly be denied. In 1971 the SEC acknowledged as much in a letter to Senator Magnuson in which the SEC proposed that its '35 Act functions be transferred to the Federal Power Commission (FPC). In that letter, then Chairman Casey wrote:

2/ As is the case for any person, PGandE is subject to the requirements of section 9(a)(2) concerning utility acquisitions.

3/ Although PGandE would initially qualify for an exemption, exemptions may be revoked or conditioned at any time by the SEC due to changed circumstances. In the event PGandE created a parent holding company and subsequently lost its exemption, it would become subject to the '35 Act. Under the corporate simplification process applicable to utilities subject to the Act PGandE might be required to divest either its gas or electric business to meet the "single integrated utility" standard applicable to holding companies. It is this possibility above all others which has precluded PGandE from activities which might conceivably bring PGandE within the confines of the Act.

> "[t]he principal mission entrusted to the Commission by the Congress through enactment of the Public Utility Holding Company Act was largely accomplished during the first twenty years of the Act's history. This was to eliminate or reorganize the complex, unwieldly, and unsound utility holding company structures which had been built up during the 1920s and which Congress determined to be contrary to the public interest." (CCH Fed. Sec. Law Rept. '72-73 Dec. ¶78,928)

To the extent that Chairman Casey acknowledged that the SEC was then actively engaged in '35 Act activities, it was either in connection with securities issuances and minor acquisitions by registered holding companies, or in considering large scale multiutility generating plant projects. 4/ As to the latter, Chairman Casey opined that the FPC had already been involved in evaluating those projects for a number of years and that in any event:

> "the nature and motivation of this [generating station] development is, however, quite different from that which existed in the 1920s. Then, holding company empires were built up primarily as promotional ventures accomplished by the manipulation of corporate structures for the profit of those who engaged in these activities. The current interest is more a response to technological developments . . . ." [Id at p. 81,994]

In the utility industry, as in other parts of the nation's economy, the structural concerns which may have been appropriate in the 1920s no longer are valid today. During those times the electric utility industry was in the stage of transition from multilayer local generation and distribution formats to the present day large integrated, reliable generation, transmission, and distribution structures. Although the technology is complex, the

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4/ In adopting Rules 14 and 15 earlier this year the SEC has in many respects disclaimed the need to evaluate the effects of large scale multi-utility generating plants, at least where it is assumed that other state and federal agencies are reviewing those projects.

structural complexity has largely disappeared as utility systems merged, matured or, in some cases, were divested.

Similarly, the regulatory environment has changed considerably since the 1920s. To the extent that the '35 Act was largely a reaction to securities manipulation and accounting abuses, the present environment bears no relationship to that time. Not only has the SEC's involvement, in the form of the enforcement of the Securities and Exchange Acts of 1933 and 1934, dramatically shaped present disclosure and accounting practices, but the FPC (now FERC) uniform system of accounts has also controlled the abuses focused on in the '35 Act.

At the state level, the regulatory oversight and control has been no less pervasive. In California, for example, PGandE's activities in the securities area must conform to both the applicable provisions of the California Corporation Code (e.g., section 500 et seq. governing distributions to shareholders) and to the close securities oversight exercised by the CPUC.

In view of this substantial change in both structural circumstances and in the regulatory framework since the '35 Act was adopted, it does not appear that repeal of the '35 Act would have an adverse affect on utility practices, at least as viewed from PGandE's perspective. As applied to PGandE (in the event a parent holding company was formed to facilitate diversification) the Act would merely duplicate the regulatory framework currently in place.

Approach Two - "One Subsidiary" Modification

As PGandE interprets this approach, the Act would be modified to allow a parent holding company to be established, provided there was only one public utility subsidiary with the holding system and that the utility subsidiary's operations were geographically limited. An exception would apply to holding companies which are presently exempt under section 3(a)(2) by virtue of the fact that they are predominantly a public utility company whose operations as such do not extend beyond the state of organization and states contiguous. In addition, Section 3 of the Act as presently written would be amended to remove the "unless and except" clause, the effect of which would be to make exemptions permanent so long as the statutory standard is met. PGandE views this latter provision as being particularly important. 5/

Generally speaking, PGandE would enthusiastically support an amendment of the sort suggested. To be functional for PGandE, however, the amendment should provide that an existing combination gas and electric utility company will be construed to be a single public utility subsidiary for the purposes of the exemption. 6/ In PGandE's case such an amendment would remove a key structural obstacle to diversification and would greatly increase the likelihood that some form of diversified activity would occur. Of course, whether in fact PGandE would engage in any diversified business activities would ultimately depend on whether the perceived benefits for its shareholders would outweigh the risks associated with that activity and whether it is able to devote capital to those activities.

Although enactment of the "one subsidiary" exemption would remove the '35 Act regulatory obsticle, PGandE does not believe that either the CPUC or PGandE ratepayers would be compromised as a result. Under sections 851 and 854 of the California Public Utilities Code the disposition or encumbrances of public utility property and the acquisition of control, either directly or indirectly, of any California

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5/ Although PGandE believes that it would qualify for exemption by rule or order under Section 3 of the Act if it were presently to create a parent holding company structure, the existence of the "unless and except" clause has prevented PGandE from doing so. PGandE believes that the inherent risk of divestiture associated with SEC withdrawal of exemptions by use of that clause have not justified the creation of a holding company. Moreover, as applied by the SEC in the Pacific Lighting Corporation case, the level of diversification currently allowed exempt companies is extremely limited.

6/ In order to facilitate certain generation projects the amendment should also provide that use of the "one subsidiary" exemption should not preclude the ability of the parent, either directly or through the subsidiary, from taking advantage of Rules 14 and 15 and other applicable exemptions for creation, in conjunction with other utilities and investors, of regional generation companies.

public utility must be approved by the CPUC. Thus, although the parent holding company would not itself be a jurisdictional entity, the CPUC would nonetheless initially be required to review the holding company-subsidiary company relationship.

Beyond the initial review, the CPUC would, of course, continue to review, monitor and regulate the activities of the public utility subsidiary to the same extent as is currently the case. In that context, the CPUC has for many years reviewed utility-related transactions between jurisdictional entities and their parents and subsidiaries and has adopted a general rule that an affiliate is not entitled to realize a rate of return on those intra-system transactions in excess of that allowed the utility by the CPUC. Given this scope of review which the CPUC has exercised in the past and the broad ambit of authority to review utility actions which affect the ratepayers and the public, there is simply no reason to believe that an amendment of the sort contemplated would adversely affect ratepayers. Indeed, to the extent that the effects at diversification are successful, the strength of the overall system and the more efficient use of current utility resources should benefit ratepayers.

INTERMOUNTAIN GAS COMPANY
BOISE, IDAHO

WALTER H. SMITH
PRESIDENT
CHIEF EXECUTIVE OFFICER

P. O. BOX 7608
83707
(208) 377-6000

November 25, 1981

Honorable Tom Corcoran
Representative 15th District
State of Illinois
1107 Longworth House Office Building
Washington, D.C. 20515

Dear Congressman:

Your inquiry addressed to Intermountain Gas Company concerning the two legislative approaches to the Public Utility Holding Company Act of 1935 has been a subject for discussion of my staff for the past two or three weeks trying to determine what if any comments we might make pertinent to your inquiry.

It occurs to me that in the first instance that efforts to avoid the obscurities stated in the preamble of the act, the state public utility commissions, since 1935, have become substantially more sophisticated and competent to regulate all utility company activities within their borders that are not otherwise preempted by regulatory acts of Congress. In addition to this, the communication and reporting capabilities of the companies, the public entities, and the media are also infinitely more competent and reliable than we had in the 30's. I think both of these observations are pertinent to your inquiry and form the basis upon which I have approached your questions.

APPROACH ONE

Question One: Because of various regulatory agencies and obligations of disclosure, the utility industry probably no longer presents the unreachable complexities that the Act intended to correct.

Question Two: The state and federal laws are now adequate to protect stockholders and ratepayers.

Question Three: There are presently areas of conflict between state regulatory agencies, but these seem to find resolution in the day-to-day responsibilities of these agencies.

Question Four: I would say that the ratepayers of Idaho look upon the State Public Utility Commission as the sole protector of their rights and interests and recognizes little or no federal responsibility.

Question Five: It is doubtful that much diversification would be pursued by public utilities nor would I anticipate too many mergers because of inherent difficulty in adhering to the specific recommendations of the various accounting requirements mandated by the state and federal regulatory agencies. There may be a remote possibility that repeal of the Act could help utilities raise capital for their ever increasing needs to supply energy demands in this country.

APPROACH TWO

Question One: Diversification under the amendments therein stated may encourage limited utility diversification.

Question Two: I do not anticipate such an enactment would affect the Public Utility Commission of the utilities in Idaho.

The comments that I have made in response to your inquiries were based on limited first-hand experience and from cursory review of the Act of 1935. It is not intended to be an exhaustive research into the complex ramifications of the questions. Such an inquiry is beyond the capabilities of our staff.

I trust that these responses will be of some value to you and your committee.

Very truly yours,

Walter H. Smith

RBH:WS:plp

POTOMAC ELECTRIC POWER COMPANY
1900 PENNSYLVANIA AVE., N. W.
WASHINGTON, D. C. 20068

W. REID THOMPSON
CHAIRMAN OF THE BOARD
PRESIDENT

November 25, 1981

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The Honorable Tom Corcoran
Congress of the United States
House of Representatives
1107 Longsworth House Office Building
Washington, DC 20515

Dear Mr. Corcoran:

Thank you for your October 27, 1981 letter in which you discuss possible amendments to the Public Utility Holding Company Act. I am encouraged that you as a Congressman understand the present financial plight of the utility industry and want to take steps to alleviate its serious economic problems.

Potomac Electric Power Company (PEPCO) heartily endorses the second approach outlined in your letter regarding amendments to the Public Utility Holding Company Act., i.e., to amend Section 3 of the Act (1) to exempt holding companies with only one public utility subsidiary, provided the subsidiary's operations are limited to its state of incorporation and contiguous states; (2) to exempt holding companies created by companies that are presently exempt under Section 3(a)(2) of the Act; and (3) to remove the "unless and except" clause. These proposed amendments would allow more utilities to diversify into non-regulated businesses which would ultimately improve the financial condition of those utilities.

Not only are utilities earning far below their authorized rates of return, due to inadequate and untimely rate relief, but also those authorized returns are far below the rates necessary to obtain adequate capital on a competitive basis. Diversification into businesses outside of the public utility arena would provide utilities an opportunity to improve their financial condition by enabling them to earn a return on their investment in non-regulated industries commensurate with the risk involved.

The preferred structure for a utility wishing to undertake diversification activities is the creation of a holding company, exempt under the Public Utility Holding Company Act, with separate corporate subsidiaries for its utility and non-utility operations. This corporate structure provides the best mechanism to avoid any cross-subsidization between the ratepayers and shareholders of a public utility. Cross-subsidization should be avoided for the sake of both the ratepayer and the shareholder because the ratepayer, who would bear none of the risk of non-utility diversification, should pay only the cost of utility service, and the shareholder, who would bear all the financial risk of non-utility diversification, should have the opportunity of financial reward.

Under the present structure of the Public Utility Holding Company Act, PEPCO could not form an exempt holding company because its utility operations extend beyond one state.* The proposed Approach 2 amendments to the Act would afford PEPCO the opportunity to establish a holding company structure with presently structured PEPCO as a corporate subsidiary. Such a structure would not impair our utility service and would allow us the opportunity to engage in other industries to improve our financial condition.

Regarding the need to remove the "unless and except" clause under the Act, such an amendment is critical to the expanded use of the holding company structure. The existence of the clause has a chilling effect on diversification activities of utilities. Presently an exemption may be revoked by the Securities and Exchange Commission; a company which loses its exempt status would be subject to the forced sale of non-utility businesses, the forced divestiture of either its gas or electric business in the case of a combination electric and gas utility, and the additional regulation imposed by the Act, including the prohibition against diversification into areas not functionally related to the utility business enterprise.

If the Act were amended to allow more utilities to engage in non-functionally related businesses through a holding company structure, PEPCO submits that there should be no effect on a diversified utility's ratepayers. All the risk (and any reward) of diversification activities should be properly with the utility's shareholders and should be treated as such by a state regulatory commission. However, to the extent that diversification benefits the utility's overall financial performance, diversification could provide indirect benefits to ratepayers.

The questionable practices which gave rise to the Public Utility Holding Company Act would not recur if the Act were amended to afford more companies the opportunity to establish an exempt holding company structure without the threat of revocation of that status. State public utility commission regulation, federal utility regulation, and accounting standards have been developed since the 1935 Act to protect the interests of investors and consumers. There is no longer any justification for subjecting the utility industry to strict federal controls which are not imposed upon other industries.

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* As you know, PEPCO serves the District of Columbia, parts of Maryland and a small section of Northern Virginia.

We urge you and the other members of your committee to continue your efforts to spur economic growth and reduce governmental regulation. In this regard, we urge you to further pursue amendments to the Public Utility Holding Company Act. We thank you for affording us the opportunity to share our views on this issue with you.

Sincerely yours,

W. Reid Thompson

COLUMBIA GAS
System

W. F. Laird
Chairman and President

November 25, 1981

The Honorable Tom Corcoran
The United States House of Representatives
Washington, D.C. 20515

Dear Mr. Corcoran:

Re: Public Utility Holding Company Act
Your Letter of October 27, 1981

I appreciate the opportunity to respond to your letter of October 27, 1981. I encourage you in your efforts to revise the Public Utility Holding Company Act to reflect the changes that have occurred since the 1920s and '30s.

We have reviewed the response to questions you raised with the two other gas utility public holding companies in existence, namely: Consolidated Natural Gas Company and National Fuel Gas Co. We agree with the answers attached to the response to you of November 23, 1981 by Mr. G. J. Tankersley, Chairman of Consolidated.

Please advise if I may be of further assistance.

Yours very truly,

WFLaird

The Columbia Gas System, Inc., 20 Montchanin Road, Wilmington, Delaware 19807

Atlantic Electric
SERVING A MILLION PEOPLE
IN SOUTHERN NEW JERSEY

Jerrold L. Jacobs
Senior Vice President - Finance

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November 25, 1981

Honorable Tom Corcoran
Representative in Congress
Congress of the United States
House of Representatives
Washington, D. C. 20515

Dear Congressman Corcoran:

In a recent letter to our Company, you proposed two potential legislative approaches to the modification of the Public Utility Holding Company Act of 1935.

We attach for your use comments of the Atlantic City Electric Company with regard to your position paper. We hope these comments prove useful to you in any future modification of the Act.

If we can be of any further assistance to you in this effort, please do not hesitate to contact us.

Very truly yours,

Jerrold L Jacobs

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Attachment

RESPONSE TO REPRESENTATIVE CORCORAN'S LEGISLATIVE APPROACH TO THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

Commentary re Question 1 of Approach Two: To what extent, if any, would this approach lead to utility diversification?

Let us take each of the three individual proposals contained within Approach Two and examine the implications for Atlantic Electric. These answers are framed from our "perspective as representing an exempt holding company filing SEC statements pursuant to Rule 2".

"Approach Two: Amend Section 3 of PUHCA,

1. first, to exempt holding companies with only one public utility subsidiary, provided such subsidiary's operations are limited to its state of incorporation and contiguous states; ..."

Comparison to original PUHCA: See Section 3(a)(1) which exempts "any holding company and any subsidiary company thereof ... if

1.) such holding company and every subsidiary company thereof which is a public utility company ... are predominantly intrastate in character and carry on their business substantially in a single state in which such holding company and every such subsidiary company thereof are organized; ..."

AE's corporate structure (with the Deepwater Operating Company subsidiary, itself a public utility) is such that it would appear to qualify for exemption under both original and amended Section 3(a)(1). The broadening of the allowable geographical area under amended Section 3(a)(1), however, would have limited impact on any AE diversification decision. Indenture restrictions contained in AE's mortgage and deed of trust can still be an impediment to diversification since AE is both an electric utility and a conditionally exempt holding company.

2. "second to exempt holding companies created by companies that are presently exempt under Section 3(a)(2) of the Act; ..."

Comparison to original PUHCA: See Section 3(a)(2) which exempts "... any holding company and any subsidiary company thereof ... if

> 2.) such holding company is predominantly a public utility company whose operations as such do not extend beyond the state in which it is organized and states contiguous thereto; ..."

We assume by this proposal that the original Section 3(a)(2) exemption will be left in force. It is our opinion, considering AE's corporate structure, that Section 3(a)(2) is also an applicable exemptive provision. AE is currently considering diversification options. However, in our opinion, indenture restrictions contained in AE's mortgage and deed of trust can still act as a constraint on diversification.

3. "third, to remove the 'unless and except' clause." Comparison to original PUHCA: See Section (3) which reads as follows:

"SEC. 3.(a) The Commission, by rules and regulations upon its own motion, or by order upon application, shall exempt any holding company and every subsidiary company thereof as such, from any provision or provisions of this title, unless and except insofar as it finds the exemption detrimental to the public interest or the interest of investors or consumers, if ..." (emphasis added)

In order to properly analyze the probable effects of the removal of the "unless and except" clause, it is necessary to examine current interpretations of the question of diversification versus public interest as regards a conditionally exempt holding company. The SEC, in the Pacific Lighting Case, developed guidelines as to what it considered "prudent and limited diversification" for Section 3(a)(1) conditionally exempt holding companies.

1. All non-utility activities should be segregated from utility activities through separate corporate subsidiaries.

2. There should be no services, materials or other contracts between the utility and the other subsidiaries except to the extent such contracts are subject to the supervision of state regulatory commissions.
3. There should be no use of utility operating management, funds or credit for non-utility purposes.
4. With respect to any non-utility activity or business which does not have a functional or operating relationship to the utility business, we would require that non-utility investments, both individually and on an aggregate basis constitute only a relatively small component of the entire system.

With regard to this topic, however, we have learned that "the practice of the SEC staff is not to look at the degree of diversification .... There is not even a 50% utility vs. non-utility related activity threshold for staff action. Instead, the staff looks to see whether the nature of the diversification and the financial transactions that accompanied it have put the financial health of the holding company and/or utility subsidiaries in jeopardy."

5. Non-utility investments should be restricted to activities which are either complementary in a significant way to the utility operations or have an established and successful record, such as a history of stable or increasing earnings for a reasonable period of time.

In our opinion, the above guidelines largely parallel the requirements which a prudent management team would impose on itself. The only real restriction these guidelines create would be in the case where the conditionally exempt holding company wished to start "from scratch" a business which was not "complementary in a significant way to the utility operations" (or in the case where the holding company wished to buy a faltering business enterprise which was not "complementary ...").

The effect of removing the "unless and except" clause is to eliminate the basis for the SEC's having to decide when diversification is contrary to the public interest or the interests of investors or consumers. The guidelines currently used by the SEC are, as we have seen, rather liberal (not far removed from the self-imposed requirements of prudent management). However, they could change, perhaps become stringent, as the result of legislation, SEC policy or rule changes or judicial or SEC decisions. If the criteria became less liberal, holding companies would be faced with possible forced divestiture of profitable subsidiaries. The removal of the "unless and except" would allow more wide-ranging diversification and would remove much uncertainty among management as to later forced divestiture. However, even if the "unless and except" clause were removed, indenture restrictions would still act as a constraint on diversification for companies structured in the same manner as AE.

In sum, it is our opinion that the proposed changes will have relatively little practical effect on diversification activities at Atlantic Electric.

Question 2

1. Effect of enactment on our state PUC (New Jersey Board of Public Utilities).

Diversification has been termed a "natural enemy" of state regulatory commissions. Recently the Wisconsin Public Service Commission determined in a policy statement that it has jurisdiction over formation of holding companies by utilities in the state. We are not aware of any similar policy statement issued by the New Jersey BPU. In any case, AE is already a conditionally exempt holding company.

We know of no real statutory power possessed by the BPU at this time that would block diversification by AE under the existing or amended PUHCA. The only weapon possessed by the BPU to discourage diversification would be to delay rate relief.

2. Effect of enactment on utilities.

This depends upon, first, the current corporate structure of the utility involved - whether it is solely an electric (or gas) utility or a utility that is part of a holding company structure. Secondly, any future action by the NJBPU similar to that taken by the Wisconsin Public Service Commission would have a profound effect on those utilities that are not already part of some holding company structure.

We believe that the legislation would have little effect (given current SEC position on and interpretation of diversification issues for conditionally exempt holding companies) on utilities situated similarly to AE.

3. Effect of enactment on stockholders.

We believe that enactment would have a favorable impact on our stockholders and on the financial community in general. Even if utilities do not take full advantage of the amendments, the announcement effect of the amendments would indicate that Congress is becoming serious about the financial problems of the utilities.

4. Effect of enactment on ratepayers.

Loosening of existing PUHCA requirements would probably be met with resistance by consumer advocate groups. They believe that holding companies connote big business and anti-consumerism. In our opinion, they would oppose legislation which would broaden the exemptive provisions and would at least appear to broaden the allowable diversification.

MONTANA POWER COMPANY mpc GENERAL OFFICES · 40 EAST BROADWAY, BUTTE, MONTANA 59701 • TELEPHONE 406/723-5421

JOSEPH A. McELWAIN
CHAIRMAN OF THE BOARD
and
CHIEF EXECUTIVE OFFICER

NOV 27 1981
DAN'S NOTES

November 24, 1981

Hon. Tom Corcoran
House of Representatives
Washington, D.C. 20515

Dear Mr. Corcoran:

Your request for a response to two possible legislative approaches to the Public Utility Holding Company Act of 1935 (PUHCA) is somewhat challenging for The Montana Power Company (the Company) to answer, for reasons which appear below.

The Company is not a holding company under PUHCA at present, but it is highly diversified through ownership of a number of subsidiaries. This diversification is primarily confined to energy-related activities in coal, oil, and natural gas in Canada, Montana, Wyoming and Texas. Expansion of these activities to other states is in contemplation. Additionally, generally as an incident to other operations, the Company has established such things as an aircraft sales, service and charter business, a shopping center, an industrial park, and a small water and sewer utility, all in Montana.

We are, therefore, facing the PUHCA from a somewhat different aspect than companies seeking to diversify. We are diversified, and are seeking the appropriate structure for that diversity. The PUHCA has features which cause us real concern, as will appear below. However, we have not advocated or suggested repeal of PUHCA, your Approach One, because it goes beyond our needs. In that context, then, we respond to the questionnaire.

APPROACH ONE: Repeal of the PUHCA.

Question 1. In my experience utility companies generally do not present problems of size and undue structural complexity. This

Company is, perhaps, complex, but in a functional way and for good business reasons. For example, our coal subsidiary, Western Energy Company, itself has a subsidiary, Northwestern Resources Co. But that subsidiary was created solely because the corporate name of Western Energy was not available for use in Wyoming and Texas, where we have coal and lignite properties. Canadian-Montana Pipeline Company is a separate corporation, chartered by the Parliament of Canada, because Canadian law requires it to have that status. Other examples could be given from our corporate complex.

Question 2. If the PUHCA were repealed, there would still remain a substantial system of checks upon corporate behavior in other laws administered by the SEC, plus conditions of the Federal Power Act, the Natural Gas Act, and disclosures and reporting under those acts, plus state regulatory controls.

Question 3. I cannot predict whether repeal of PUHCA would result in conflicting state regulation. It is, of course, possible, but whether states would be anxious to assume the added costs of regulation may be doubtful.

Question 4. In Montana, the PSC is elected, and presumably the voters have confidence in those they elect. Here, I think the PSC is perceived by the public as having the premier role in utility regulation, with the federal role less clearly perceived.

Question 5. In my opinion, repeal of PUHCA would not, in and of itself, have any effects upon our PUC, shareholders or ratepayers beyond what we believe to be the beneficial effects achievable under your Approach Two. Repeal, like amendment, would facilitate a more appropriate organizational structure for the Company.

APPROACH TWO: Amend the PUHCA in the Manner Described.

Question 1. This Company's situation precludes me from answering for this Company, because it is diversified and for other companies, because I do not know. Montana Power is a diverse company in search of a proper structure, not a company searching for a proper structure so that it may diversify. But, if it were not diversified, it would not look to the Act in its present form as an aid in doing so, and for these reasons.

(A) The Montana Power Company is a combination company, providing electric, gas (and, through a subsidiary, water and sewer) service. The bias of the Act against combination companies is a formidable deterrent, because of the prospect of forced divesture of either the electric or the gas business, should the full weight of the PUHCA fall on us.

(B) The Pacific Lighting case suggests the danger that divesture of non-utility businesses not "functionally related" to the main remaining business might also be stripped away, absent repeal of the "unless and except" clause of the Act.

(C) This Company could not function in its present activities were it found not to be exempt, by virtue of the "unless and except" clause of the present act.

Question 2. Enactment of the amendments, which I most strongly favor, would not enhance our diversification, but would make it possible to conduct business within an appropriate structure. The effect upon ratepayers is that they would be subject only to clearly identified utility assets and operations upon which utility earnings would depend; upon stockholders, that they would enjoy fully the benefits (and suffer fully the risks) of investments from retained earnings; upon the state PUC, no enlargement or diminution of authority or jurisdiction, and hence, no real effect.

I would expect a generally beneficial effect from diversification. The ventures we have formed have been profitable, by and large. In 1980, for example, non-utility income after taxes and interest was $19,249,000, out of a consolidated net income for all utility and non-utility operations of $43,077,000. This suggests that in our case, diversification has been healthy, and certainly supportive of the overall condition of the Company and its subsidiaries.

Very truly yours,

Joe McElwain

J. A. McElwain

JAM/WJC/pb

Public Service
Electric and Gas
Company

Robert I. Smith
Chairman of the Board

80 Park Plaza, Newark, NJ 07101 Mailing Address: P.O. Box 570,

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November 24, 1981

Honorable Tom Corcoran
Congress of the United States
House of Representatives
Washington, D. C. 20515

Dear Congressman Corcoran:

As indicated in your letter to me of October 27, 1981, there is concern about the financial plight of the utility industry. We wholeheartedly support your interest in removing Federal statutory and regulatory barriers that may inhibit the ability of utilities to financially help themselves, their stockholders and rate payers. We further agree that changes to the Public Utility Holding Company Act of 1935 would provide some relief.

As a result, we are presently participating with a group of other public utilities which is seeking to amend Section 3 of the Public Utility Holding Company Act along the lines of your "Approach Two" with the hope that such a limited change can be adopted expeditiously. We also feel that repeal of the Act ("Approach One" in your letter) would provide the maximum benefit for utilities, but we are concerned that the legislative process involved in repeal could be an extended one. To the extent that relief is delayed, of course, the benefits are more tenuous. We therefore favor "Approach Two" included with your letter, for help in the near term. We would hope, however, that Congress would ultimately repeal the Act.

In specific response to your discussion paper, we believe that under Approach One, Questions 1 and 2, utility companies do not presently present the problems of size and structural complexity the Act was designed to correct. As a result of the Act, various divestiture proceedings were carried out by the Securities and Exchange Commission, resulting in the desired simplification. Moreover, the Securities Act of 1933 and the Securities Exchange Act of 1934, also administered by the SEC, have proved to be far more effective regulatory tools than originally perceived at the time of their adoption. Therefore, the complexities of structure and abuses designed to be remedied by the Holding Company Act could not exist today in the form or manner in which they were present back in 1935. The full disclosure provisions of the Securities Act and the continuous reporting requirements of the Exchange Act are sufficient Federal regulatory tools to assure that the purposes of the Public Utility Holding Company Act continue to be followed and that investors and shareholders are adequately informed as to the financial condition and operations of public utilities. Further, present day state regulation of utilties exists to the extent that a comprehensive Federal regulatory scheme is no longer required.

With respect to your Questions 3 and 4 under Approach One, repeal of the Holding Company Act would not result in any conflicting State regulation with respect to this Company, since our retail operations are wholly within New Jersey. Also, since this Company is not presently a holding company, repeal of the Act would not affect our regulation as it presently exists. However, it would permit the Company to diversify through a holding company without the fear of an SEC required divestiture of the electric business from the gas business or of subsidiary operations which are not "functionally related" to utility operations. We believe that repeal of the Holding Company Act would lead to diversification in the utility industry and that by broadening the operations of utility companies stockholders could be provided a better investment, without detriment to utility rate payers.

We also believe that under Approach Two, utility diversification would result. Again, such enactment would not affect our State public utility regulation, and any resulting diversification would not have an adverse effect on our rate payers but could enhance our stockholders' investment.

We hope our responses will be helpful in your effort to reduce the Federal regulatory burden on public utilities. If we can be of any further assistance, please do not hesitate to contact me or John F. McDonald, our Senior Vice President - Governmental Affairs.

Sincerely,

Robert J. Smith

**Consumers
Power
Company**

General Offices: 212 West Michigan Avenue, Jackson, MI 49201 • (517) 788-1111

W R Boris
Executive Vice President, Finance

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November 24, 1981

The Honorable Tom Corcoran
1107 Longworth House Office Building
Washington, DC 20515

Dear Congressman Corcoran:

By letter dated October 27 you advised of your concern with the financial condition of the utility industry, and specifically addressed the matter of possible repeal or amendments to the Public Utility Holding Company Act of 1935.

The first approach postulated in your letter is total repeal of PUHCA, an action which we do not believe is needed in view of Approach Two, which is a more limited amendment of the Act.

Specifically, utility companies do not today present the problems of size and complexity which the original act was intended to correct. According to investigative reports which led to the adoption of the Act, several large holding companies had literally hundreds of subsidiaries, with a pyramidal structure which resulted in highly leveraged companies, often with a minimal equity investment, controlling billions of dollars of assets and revenues. Allegedly, this also led to securities price manipulation, utility plant cost write-ups and inaccurate or misleading accounting methods. The present level of both Federal and State regulatory and reporting mechanisms make it virtually impossible for any of the alleged past abuses to go undetected or uncorrected. Since the passage of the Act, state public service commissions have grown in size and sophistication so that the public has more confidence in state regulation than it does in an agency remotely located in Washington. Repeal of the Act would encourage diversification for reasons listed under Approach Two and, if such diversification were properly undertaken into unregulated businesses, could provide sources of revenues which enhance the financial strength of the overall enterprise. This in turn would enhance credit worthiness, securities ratings of the parent company and result in lower securities costs and, therefore, reduce the upward impact on ratepayers costs. Likewise, it would moderate the impact on stockholders of the dilution caused by issuance of new equity securities.

With respect to Approach Two, which is favored by this Company, similar opportunities would be presented for diversification, but more closely to what most utilities want to be permitted to do. It would permit a holding company to be created to own and operate separate areas of utility and nonutility functions, thus permitting clearly identifiable accounting of investment and costs for each of the activity areas. By such a separation, the benefits of successful nonregulated diversification could benefit the stockholder of the parent and reflect improved market price and stronger possibility of regular dividend increases. Improved market price of the parent's common stock would again reduce the dilution impact of new securities sales.

Our Company is a combination electric and gas company and, to us, the elimination of the "unless and except" clause is of paramount importance in order not to be faced with a forced divestiture. Further, as costs of generating facilities continue to escalate, the benefits of joint equity ownership among several electric companies of major generating subsidiaries would spread cost and risk to more manageable size. Any efforts to diversify, either for enhancement of financial stability or spread of risk, is inhibited by the threat of revocation of exemption by the "unless and except" provisions.

We strongly favor Approach Two as a reasonable amendment which would enhance prudent diversification for the benefit of the companies, their stockholders and ratepayers.

Very truly yours,

W R Boris

W R Boris
Executive Vice President - Finance

Eastern

Eastern Gas and Fuel Associates
One Beacon Street
Boston, Massachusetts 02108
(617) 742-9200

W. J. P
President

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November 23, 1981

The Honorable Tom Corcoran
1107 Longworth House Office Building
Washington, D. C. 20515

Dear Congressman Corcoran:

This is to acknowledge receipt of your letter dated October 27, 1981 concerning possible legislation affecting the Public Utility Holding Company Act of 1935.

You are aware, I am sure, that Eastern Gas and Fuel Associates is an exempt holding company under §3(a)(1) of the statute, the so-called intrastate exemption. We are not unhappy with the status quo. We have found the staff of the Securities and Exchange Commission to be cooperative and reasonable, and I do think that those who advocate outright repeal of the statute carry a heavy burden of demonstrating that the old evils of pyramiding and geographical dispersion would not recur. Clearly none of the disclosure provisions of the other statutes administered by the Securities and Exchange Commission would be a substitute for §§6, 7, 9 and 10 of the Public Utility Holding Company Act, which regulate sales and purchases with a view to preventing a return of the evils that the geographical integration and corporate simplification provisions of §11 of that Act were designed to cure.

It occurs to me also that there is really nothing in the Holding Company Act to prevent diversification of electric or gas companies as long as they do not create public utility holding companies. That is to say, an electric or gas operating company is free, so far as the Holding Company Act is concerned, to organize as many non-utility subsidiaries as it likes. The catch is that the state utility commissions might well have something to say in that event. In other words, the real impediments to diversification come from state law, not federal. Thus, what the proponents of repeal really want, it might be argued, is to be free of any control, whether federal or state, so far as diversification is concerned. Whatever the merits of diversification, further thought must be given to the relative safety, particularly in view of the background of abuses that produced the Holding Company Act, of permitting unchecked diversification.

I appreciate this opportunity to express our views.

Sincerely,

William J. Pruyn

William J. Pruyn

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CONSOLIDATED NATURAL GAS COMPANY
Four Gateway Center
Pittsburgh, Pennsylvania 15222

G. J. TANKERSLEY
Chairman

November 23, 1981

The Honorable Tom Corcoran
The United States House of Representatives
1107 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Corcoran:

This is to acknowledge your letter of October 27, 1981.

I support your expressed desire to remove federal statutory and regulatory barriers which inhibit a utility's ability to improve its financial status, and welcome this opportunity to comment specifically on the Public Utility Holding Company Act of 1935 (the 1935 Act).

The objectives of the 1935 Act are now met by a combination of State and Federal acts and regulations. The 1935 Act is therefore duplicative and its continuation serves no useful purpose. In addition, it places undesirable restrictions upon both the timing and methods of financing of regulated companies and limits the ability of such companies to diversify into non-regulated energy-based endeavors in furtherance of their long-range corporate goals. Maximum flexibility to expand the energy-related activities of our company is essential to its financial health.

I also stress the need for Congress to recognize the fundamental differences between the electric utility industry and the natural gas industry (see answer to question 5), because of which a sound solution for one industry may be inappropriate for the other.

I attach answers to the seven questions raised by your letter. If I can provide additional information, please let me know.

Respectfully submitted,

GJ Tankersley

Attachment

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

Two Legislative Approaches

Approach One: Repeal the PUHCA with provisions stating that such repeal would not affect any PUHCA proceedings previously commenced.

Question 1: To what extent, if any, do utility companies continue to present the problems of size and structural complexity the Act was intended to correct? Please specify.

None. Since 1935 many companies have reorganized so that they are no longer public utility holding companies. Other companies have reorganized to confine their organizations to a single state so that they are exempt from the Act's regulation. Today only 13 companies, including three gas holding companies, are subject to the Act. The task assigned to the Securities and Exchange Commission of dismantling and reconstructing the mammoth utility systems of the twenties is completed.

Even if the Act is repealed, it would be virtually impossible for a public utility holding company desiring to implement a financial structure like that which Congress found abhorent in 1935 to find a public market for its securities. The rating services (if the issue were debt or preferred stock) would give it unacceptable ratings, sizable investment banking firms would shun the offerings and the analyst community would quickly expose the dangers inherent in such financial structures. In effect, the market would provide the necessary disclipline to assure that improper and dangerous financial practices were not engaged in.

Question 2: To what extent would federal and state law adequately protect the interest of stockholders and ratepayers were PUHCA to be repealed?

A detailed examination by a major law firm1/ clearly demonstrates that other federal and state legislation2/ duplicates the PUHCA and that the interest of stockholders and rate payers would be adequately protected even if the PUHCA were repealed.

In summary, the primary abuses of which utility holding companies were guilty prior to the PUHCA included undesirable accounting practices, the issuance of securities on the basis of arbitrary markups of asset values, and the creation of paper profits through transactions between affiliated corporations. Each of these abuses is proscribed by existing statutes and regulations other than PUHCA.

1/ Morgan, Lewis & Bockius of Washington, D.C.

2/ While the detailed examination of state law was limited to New York, Ohio, Pennsylvania and West Virginia, it is believed that most, if not all, other states have basically similar statutes.

1. Undesirable Accounting Practices

Undesirable accounting practices are a thing of the past. Under the Public Utility Holding Company Act of 1935 (the 1935 Act), the SEC has imposed a uniform system of accounts on registered companies. However, under the Securities Act of 1933 (the 1933 Act) and the Securities Exchange Act of 1934 (the 1934 Act), the SEC has very broad power to establish standards for the form and content of financial statements. The SEC has exercised that power through Regulation S-X and 300 Accounting Series Releases. Moreover, since 1935, the states and the Federal government have adopted uniform systems of accounts for public utility companies pursuant to authority granted by other statutes.

In 1935, these accounting principles barely existed. The American Institute of Accountants now the American Institute of Certified Public Accountants (AICPA) was first established in 1932 and did not estalish its Committee to issue statements on accounting principles until 1935. Since then, under the stimulus of the SEC, the demands of investors, and of Congress, the accounting profession has established an elaborate mechanism for the development of accounting principles and effective means of compelling their use. All of the registered public utility holding companies are already required to file with the SEC and send to their shareholders financial statements reviewed by independent public accountants. If those statements are prepared in accord with Financial Accounting Standards Board (FASB) principles, they are viewed as having authoritative support. The FASB and its predecessor, the Accounting Principles Board, have introduced into accounting a high measure of uniformity.

The Foreign Corrupt Practices Act adopted in 1977 and the implementing rules adopted by the SEC also prohibit the falsification of books and records and mandate the maintenance of satisfactory internal accounting controls. Under prevailing principles, assets must be carried on financial statements at their historical cost and amortization or depreciation must be based on those values.

In 1935, the SEC had not developed the concept of its authority to so discipline professionals and the disciplinary mechanism of the accounting profession was not well developed. Both are now.

2. Fraudulent Issuance of Securities

Similarly, remedies for the fraudulent issuance of securities are provided for under other statutes. All public utility holding companies presently registered under the 1935 Act are also registered under the 1934 Act which requires continuous disclosure by subject companies. All such companies are also subject to the 1933 Act when making a public distribution of securities. The disclosure concepts in the 1933 and 1934 Acts had been little developed when the 1935 Act was adopted. Since that time, however, these concepts have been extensively developed, with the result that they impose upon companies extensive disclosure requirements far beyond anything foreseen in 1935. Extensive financial statements are required to be disclosed both in connection with offerings and on a continuous basis, as is information concerning the nature of the company's business, its properties, its management, and its capitalization. Were the 1935 Act to be eliminated, there would be virtually no change in the amounts or types of information which would have to be disclosed to the public by public utility holding companies.

3. Transactions with Affiliates

The opportunity to create the illusion of profit by transactions between affiliates also would remain adequately regulated. In 1935, transactions between affiliates were not regulated by state authorities. Today, state commissions generally have this power.

Under Regulation S-X (which must be followed for all 1933 and 1934 Act filings) significant transactions between "related parties" must be disclosed in footnotes to the financial statements. The term "related party" is defined to include a party with the ability to significantly influence the management or operating policies to the extent that the company might be prevented from pursuing its own interests.

Question 3: Would the repeal of PUHCA result in conflicting state regulation? To what extent, if any, would this affect the public interest?

No. The states would retain their existing jurisdiction.

Question 4: Does the public have enough confidence in their state PUCs to reduce the federal role in regulation of local utilities?

The public is not generally aware of any federal role in regulation of local utilities.

Public perception of state PUCs varies with consumers' subjective impressions of retail rates - which is not within the purview of the PUHCA.

Question 5: In your opinion, how would repeal affect your state PUC, the utilities, stockholders, and ratepayers? In particular, to what extent, if any, would repeal of PUHCA lead to diversification?

The jurisdiction of the state PUCs would not be expanded beyond regulation of the local utility and of transactions between the local utility and its affiliates. The state PUCs should not have authority to regulate non-utility activities of affiliates which do not directly involve the local utilities.

Repeal of the PUHCA would eliminate the necessity of obtaining approval of the SEC as well as the state PUCs for intrasystem financing of day-to-day utility operations. Currently, such financings require approval of both commissions, and the SEC is asking for a minimum of 60 days in which to process an application.

Regulation of affiliate transactions by local PUCs should effectively prevent any adverse effect of repeal of the PUHCA. There should be no drain on utility assets which, in turn, will prevent utilities from subsidizing nonutility activities. Correspondingly, repeal should inhibit the abusive practice of some state commissions which have repeatedly denied adequate rates to holding company subsidiaries under their jurisdiction, compelling a diversion of earnings from other states or activities to subsidize that utility's operation.

Repeal should have no effect upon utility rates except an anticipated decrease in the cost of capital resulting from increased flexibility in financing. Stockholders should benefit from repeal and the diversification which would be expected to result.

Utility returns are diminishing, and as gas costs increase, more and more incentive will be created to keep costs to consumers low by keeping the return on equity down. If a gas utility is forced to stay strictly limited to gas distribution, the result could be an unmarketable gas company stock. Through diversification, a company may have an opportunity to broaden the investment attractiveness of its stock and to provide better for the future needs of its customers.

The fundamental differences in the basic nature and operations of the remaining registered electric and gas public utility holding companies should also be recognized. These differences include:

(1) Some electric holding companies don't wish to be exempt.

(2) The three gas holding companies still under the Act are substantially localized in the Northeast[1/] which is projected to be a no-growth region -- the electrics under the Act serve throughout the nation.

(3) Gas is a finite resource.

(4) There are no giant appliance manufacturers such as General Electric (a) doing research on new gas appliances, or (b) with such mass marketing capabilities.

(5) There are a limited number of uses for gas, particularly in the residential market, as compared with relatively unlimited electric uses.

Approach Two: Amend Section 3 of PUHCA, first, to exempt holding companies with only one public utility subsidiary, provided such subsidiary's operations are limited to its state of incorporation and contiguous states; second, to exempt

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[1/] Consolidated Natural Gas Company, Columbia Gas Company, Inc. and National Fuel Gas Company all serve Ohio, Pennsylvania and New York. Consolidated and Columbia serve West Virginia and Columbia also serves Virginia, Maryland and Kentucky.

holding companies created by companies that are presently exempt under Section 3(a)(2) of the Act; and, third, to remove the "unless and except" clause.

Question 1: To what extent, if any, would this approach lead to utility diversification?

Question 2: In your opinion, how would enactment affect your state PUC, the utilities, stockholders, and ratepayers? In particular, to what extent, if any, would enactment lead to diversification?

This approach would not be meaningful to two of the three existing gas holding companies subject to the 1935 Act since they have a number of utility subsidiaries, each incorporated in its state of operations. For a single utility to operate in more than one state often entails incorporation in each state and in all cases would involve a degree of overlapping state regulation. In short, this approach would subject multi-state utility operations to the regulation of all states in which the utility operated. It would be far preferable to allow more than one public utility subsidiary so long as each such subsidiary's operations are regulated by the state of operation.

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Wisconsin Electric POWER COMPANY
231 W. MICHIGAN, P.O. BOX 2046, MILWAUKEE, WI 53201

November 23, 1981

The Honorable Tom Corcoran
Representative in Congress
1107 Longworth House Office Bldg.
Washington, D. C. 20515

Dear Representative Corcoran:

In reply to your letter of October 27, 1981, I appreciate the opportunity to express the position of Wisconsin Electric Power Company with respect to potential proposals to repeal or to amend significantly the provisions of the Public Utility Holding Company Act of 1935. I note with encouragement your interest in removal of federal barriers that may inhibit the ability of utilities to financially help themselves and their stockholders and ratepayers.

Before I respond to the specific questions raised in the attachment to your letter of October 27, I should emphasize that Wisconsin Electric is, as you note in your letter, a holding company exempt from the Holding Company Act by order of the Securities and Exchange Commission. The result of the exemption (which has been in effect for more than a quarter century) is that our ongoing activities are not and have for a long time not been directly impacted by the restrictions in PUHCA. On the other hand, however, PUHCA has had an adverse effect upon managerial decisions of an organizational nature. For example, some years ago we had determined that some financial advantages could be obtained by organization of a new subsidiary to own a power plant we were about to build. Ultimately, we decided that the power plant should be owned directly by Wisconsin Electric. In large part, the reason for the decision was the opinion of counsel that a new public utility subsidiary in our corporate structure would result in loss of our exempt status under the PUHCA. It was our reluctant conclusion that the financial benefits of the contemplated organization would have been cancelled out by the regulatory costs and complications of registration under PUHCA.

Turning now to your specific questions:

APPROACH ONE: Repeal the PUHCA with provisions stating that such repeal would not affect any PUHCA proceedings previously commenced.

Question 1: To what extent, if any, do utility companies continue to present the problems of size and structural complexity the Act was intended to correct? Please specify?

The circumstances of the gas and electric utility industry today bear little resemblance to those in the 1920's and early 1930's which led to enactment of PUHCA along with many other federal and state statutes. Most of the utility industry nationwide was then under the control of a small number of holding company systems. State and local regulatory bodies had, in most states, neither the resources nor the legal authority for effective regulation of these complex interstate holding company systems. The picture has changed radically in the past nearly half-century both in terms of the sophistication and powers of the state and federal regulatory authorities and in terms of the composition of the utility industry itself. Even leaving PUHCA aside entirely, there has been in place for decades a pervasive state and federal regulatory aggregate which exercises effective control in the public interest over virtually every aspect of a utility's business (insofar as it relates to the provision of and charges for utility service) whether the utility is local or interstate and whether it is independent or a part of a holding company system. In short, times have definitely changed.

Question 2: To what extent would federal and state law adequately protect the interests of stockholders and ratepayers were PUHCA to be repealed?

In my view, and in the circumstances of Wisconsin Electric Power Company, the pervasive state and federal laws now in place (including, for example, state and federal antitrust and securities laws) provide entirely adequate protection for stockholders and ratepayers and would not, in my judgment, be any less effective in doing so were PUHCA to be repealed.

Question 3: Would the repeal of PUHCA result in conflicting state regulation? To what extent, if any, would this affect the public interest?

In the case of an exempt holding company, I do not see that repeal of PUHCA would result in any conflicting state regulation beyond that which exists even now. The case of the registered holding companies might, however, be different in this respect, but I do not presume to answer in their behalf.

Question 4: Does the public have enough confidence in their state PUCs to reduce the federal role in regulation of local utilities?

Since state regulatory bodies have the unpleasant task of making necessary, but unpopular, decisions with respect to highly controversial matters, it is not surprising that they are frequently the targets of political opportunism and irresponsible news media treatment. Inevitably, this kind of unrelenting pressure will tend to have an effect upon public confidence. But the remedy for this sort of thing does not, in my judgment, reside in transferring politically sensitive decisions involving essentially local matters to Washington or retaining them there. To answer your question more directly, I do believe that the public in Wisconsin has enough confidence in the state public service commission to reduce the federal role in regulation of local utilities.

> Question 5: In your opinion, how would repeal affect your state PUC, the utilities, stockholders, and ratepayers? In particular, to what extent, if any, would repeal of PUHCA lead to diversification?

Because Wisconsin Electric Power Company is, as noted several times above, an exempt utility under PUHCA, repeal of the Act would, I believe, have minimal effects on ordinary, ongoing utility activities. What repeal would do, though, is to remove the artificial and arbitrary constraints PUHCA places on our Company's ability to organize itself in the most effective way. With respect to possible diversification, it is my judgment that repeal of PUHCA would have no effect whatever on our circumstances. We believe that it is possible for us under present law to obtain the necessary approval of the Securities and Exchange Commission under PUHCA for a reasonable amount of diversification and to remain an exempt system. In fact, we have an application presently pending with the SEC for such approval. In our particular case, however, the state Public Service Commission has decided that its approval is also required for diversification. That Commission has determined that it will initiate a rulemaking proceeding to set out the criteria for obtaining such approval and to announce the conditions upon which such approval might be given. This course of action by our state Commission makes somewhat academic in Wisconsin the whole question of change or repeal of PUHCA.

> APPROACH TWO: Amend Section 3 of PUHCA, first, to exempt holding companies with only one public utility subsidiary, provided such subsidiary's operations are limited to its state of incorporation and contiguous states; second, to exempt holding companies created by companies that are presently exempt under Section 3(a)(2) of the Act; and, third, to remove the "unless and except" clause.
>
> Question 1: To what extent, if any, would this approach lead to utility diversification?

For the reasons stated above, we believe that we can qualify under present law for SEC approval of our proposed restructuring for the purpose of diversifying. For this reason, repeal or amendment of PUHCA would not in itself lead to diversification in our case. Nevertheless, repeal of the Act or, at least, elimination of the "unless and except" clause would have the effect of eliminating unnecessary and arbitrary restrictions (particularly related to the degree of diversification) which would otherwise exist and which would have the effect of impeding the total operation's potential for success.

We assume that the proposed amendment of PUHCA as outlined in APPROACH 2 would involve the creation of additional exemptions, leaving the existing exemptions contained in Section 3 unchanged. If APPROACH 2 would change the Section 3(a)(1) exemption, it would create some difficulties for Wisconsin Electric. By limiting the Section 3(a)(1) exemption to holding companies with only one public utility subsidiary, you would make it unavailable to Wisconsin Electric, which already has (and has had for many years) another public utility, Wisconsin Natural Gas Company, as its own subsidiary, which utility would, under our restructuring approach, be a separate subsidiary of a new holding company. Further, there may, depending on the exact language of the amendment, be some difficulties for Wisconsin Electric in connection with your Section 3(a)(2) revision. Wisconsin Electric is presently exempt under Section 3(a)(2), since it is "predominantly a public utility." Recently, discussions were held with the management of a financially troubled public utility in the state of Michigan concerning its possible acquisition by Wisconsin Electric. Acquisition of that company (which would have been approved by state regulatory authorities in Wisconsin and Michigan only if determined to be in the public interest) as a subsidiary would have raised a question as to whether the Section 3(a)(2) exemption could continue for Wisconsin Electric. The alternatives would have created an unacceptable situation in which our present utility customers might have been required to subsidize the utility rates of the customers of the acquired system. Maintenance of the separate corporate status of that utility would have made it more likely that equity among the customers could be maintained and would have simplified the actual process of acquisition. Our decision not to proceed with the acquisition was principally based on economic grounds but was affected by the regulatory complications under PUHCA. Your revision to Section 3(a)(2) would not have helped.

> Question 2: In your opinion, how would enactment affect your state PUC, the utilities, stockholders, and ratepayers? In particular, to what extent, if any, would enactment lead to diversification?

Because our state Public Service Commission has decided to assert jurisdiction over utility diversification, repeal or amendment of PUHCA in the manner you describe would probably not have any significant local effect. Further, for the reasons I stated above, repeal or amendment of PUHCA would probably not have any significant effects upon Wisconsin Electric's potential for diversification.

* * *

Again, I thank you for the opportunity to express Wisconsin Electric's position on this matter. If you wish any further information, please contact me directly or, if you prefer, you may contact Mr. Nicholas A. Ricci, Senior Vice President, who is in charge of our strategic planning group.

Very truly yours,

C. S. McNeer

C. S. McNeer   President

Senior Executive Vice President

Consolidated Edison Company of New York, Inc.
4 Irving Place, New York, N Y 10003
Telephone (212) 460-4324

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November 23, 1981

The Hon. Tom Corcoran
Representative in Congress
Congress of the United States
House of Representatives
Washington, D. C. 20515

Reference: Public Utility Holding Company Act of 1935

My dear Mr. Corcoran:

I am responding, in Mr. Luce's absence, to your letter of October 27, 1981 concerning the Public Utility Holding Company Act ("PUHCA").

Your letter requests Con Edison's views concerning two proposals relating to PUHCA, the first being repeal of PUHCA, and the second being amendments to Section 3 of PUHCA to create additional exemptions and to repeal the "unless and except" clause thereof. Your letter poses several specific questions concerning these proposals.

Before addressing your specific questions, it may be helpful to state Con Edison's general concerns with PUHCA. Con Edison is an independent, publicly-held operating utility and as such is not directly affected in its day-to-day operations by PUHCA. However, Con Edison has from time to time found it necessary to give careful and intensive consideration to PUHCA in connection with certain transactions, to ensure that the transactions did not inadvertently subject Con Edison or another party to regulation as a holding company under PUHCA. In some instances significant delay or restructuring of the transaction was necessary. Moreover, Con Edison, like many other utilities, has been examining the possibility of diversification beyond regulated utility activities, although it has not undertaken any such activities up to this time. It has become apparent to us that PUHCA may present an obstacle to utility diversification. In the light of these general considerations, and the more specific ones set forth below, Con Edison believes that a repeal of PUHCA would be desirable, but would also support an amendment to PUHCA as outlined in your letter since such an amendment would go far toward eliminating PUHCA as a barrier to utility diversification.

Turning to your specific questions concerning repeal of PUHCA:

Question 1. We do not believe that utility companies continue to present the problems of size and structural complexity which PUHCA was intended to correct. It is generally acknowledged that one of PUHCA's primary goals -- simplification of corporate and financial structures of public utility holding companies -- has long since been accomplished. The undesirable aspects of complex corporate structures, at which PUHCA was in large part directed, are unlikely to recur in the present-day environment of full disclosure federal securities laws and comprehensive state regulation.

Question 2. We believe that the federal securities laws, the Federal Power Act, the Natural Gas Act and comprehensive state regulation would not only provide adequate protection to investors and ratepayers, but would have, if implemented in their present form, been sufficient to prevent the abuses which led to the enactment of PUHCA.

Question 3. We do not believe that the repeal of PUHCA would result in conflicting state regulation. It should be borne in mind that registered multi-state holding company systems are today subject to regulation by the multiple jurisdictions in which they operate. While such multiple regulatory jurisdictions may lead to occasional conflicts, the system appears to work reasonably well.

Question 4. While this is necessarily a subjective judgment, it is our impression that the general public seems to believe that a local or state regulatory agency will be more directly responsive to their needs and wishes than a necessarily more remote federal agency.

Question 5. In our opinion, repeal of PUHCA would leave intact a comprehensive regulatory system for public utilities in New York State. While repeal of PUHCA would eliminate a potential barrier to diversification, jurisdiction over diversification issues would continue to be held, as it is today, by the New York State legislative and regulatory authorities.

Turning to your questions concerning a proposed amendment of PUHCA:

Question 1. The proposed amendment would remove a significant potential barrier to utility diversification. However, as noted above, authority over this issue would continue to be held by the New York State legislative and regulatory agencies.

Question 2. Other than removing a potential federal barrier to diversification, the proposed amendment would have little effect on the utility industry, its regulators, stockholders or customers, in New York State.

Thank you for this opportunity to express our views on these proposals. If we can be of further assistance in your deliberations, please feel free to call upon us.

Very truly yours,

John V. Thornton

John V. Thornton
Senior Executive Vice President

O. C. DAVIS
Chairman

Peoples Energy Corporation

122 South Michigan Avenue
Chicago, Illinois 60603
(312) 431-4600

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November 20, 1981

Honorable Tom Corcoran
House of Representatives
Washington, D. C. 20515

Dear Tom:

This response is to your request for comments concerning possible amendments to the Public Utility Holding Company Act of 1935 (the "Act") as set forth in your letter of October 27, 1981.

The Act was designed to cure perceived abuses by public utility holding company systems, primarily those of maintaining complex capital systems, issuing inaccurate and misleading financial reports and holding concentrated economic power over utility assets located in widespread geographical areas.

As we all are aware, the economic conditions and business practices of today are vastly different than those of 1935, particularly with respect to financial disclosure. With the high standards of accurate disclosures required under the Securities Act of 1933 and Securities Exchange of 1934, there is no question that deceptive practices that may have existed prior to the passage of the Act are not widespread today.

The legislative and regulatory vacuums which existed in 1935 have been effectively filled. Many of the abuses were securities and accounting problems, not unique to utility holding companies. Effective protection against the re-occurrence of such abuses which the Act was designed to eliminate exists through now mature mechanisms under the federal securities laws, the state corporation laws, the state blue sky laws, and the state public utilities acts, coupled with the strict standards which apply to the modern accounting profession.

Given the extensive protection offered by statute or regulations other than the Act, the repeal of the Act would create no significant regulatory void. It is also important to realize the Act covers a narrow spectrum of companies. As reported in various government studies, only 14 of the 100 utility holding company systems are actually regulated under the Act. It is unlikely that a rash of state legislation would result if the Act was repealed.

The public perception of the effectiveness of the various federal and state regulatory entities is, of course, always open to subjective opinion. In Illinois, the regulation of operating public utilities by the Illinois Commerce Commission (Il.C.C.) has been diligent and pervasive. Hearings before the Il.C.C. are adversary in nature, and the utilities are required to prove that the actions which they propose to take serve the public convenience and necessity. This is not regulation by "rubber stamp"; the protection provided to the public is real.

In addition, the Illinois Public Utilities Act provides that certain transactions between public utilities and affiliated companies, such as management contracts, construction, engineering, supply, financial, purchase, sales or service agreements, are void unless approved by the Il.C.C.

The Il.C.C. thus has the authority it needs to investigate transactions within a holding company system, which relate to an operating public utility company. Prior to enactment of the Act in 1935, intercompany transactions where not scrutinized and often created excessive charges and fictional profits.

The repeal of the Act or removal of the "unless and except" clause would not appear to have a significant effect on the authority of effectiveness of the Il.C.C. which, as stated above, is extensive. Stockholders, too, would be little affected since their main protection comes from disclosure under federal securities laws and the laws regulating business practices under the Illinois Business Corporation Act.

With respect to diversification, even if all barriers were removed by repeal or amendment of the Act diversification would only occur if the management of the utility system believed it was economically justified. It should be noted, however, that fair regulation and rates that provide an adequate return on utility assets are ultimately the best method by which utilities will continue to attract necessary capital and ratepayers will receive adequate and assured service at reasonable rates.

I appreciate the opportunity you have given us to respond to your concerns. I hope this letter will be of use to you and if there are any other questions you may have please do not hesitate to contact me.

Very truly yours,

Cliff

ILLINOIS POWER COMPANY IP
500 SOUTH 27TH STREET, DECATUR, ILLINOIS 62525

November 19, 1981

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The Honorable Tom Corcoran
House of Representatives
1107 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Corcoran:

I am responding to your letter of October 27, 1981 to Wendell J. Kelley of our company concerning the "Public Utility Holding Company Act of 1935 - Two Legislative Approaches." We at Illinois Power are very appreciative of your keen understanding of the industry's problems and the constructive approaches you are considering for their solution. I know that representatives of the Company have expressed their thanks to you and your staff on a number of occasions. I join in this.

Of the approaches included in your discussion paper, Illinois Power Company favors Approach Two. We are taking active steps to seek an amendment of Section 3 of the Public Utility Holding Company Act of 1935 (PUHCA) for the purpose of accomplishing Approach Two. We have joined more than thirty other electric and gas utilities as an ad hoc group for this purpose. The New York and Washington law firm of Reid & Priest and an independent consulting firm have been engaged for this purpose. One of our counsel, Mr. George B. Pletsch of Schiff Hardin & Waite, is a member of the Steering Committee of this group.

One of the Group's functions is to provide historical and contemporaneous information which will answer in detail the five questions posed by Approach One and the two questions posed by Approach Two. I understand that lawyers from Reid & Priest and other representatives of the Group have had some preliminary discussions with you, or at least with members of your staff. In view of the comprehensive material which will be furnished you by our group, I will comment only briefly on the questions raised under Approach Two in your letter. Of Course, I will be happy to provide additional information if you desire.

You inquire in Question 1 under Approach Two, "To what extent, if any, would this approach lead to utility diversification?"

The presence of the "unless and except" clause in Section 3 of the PUHCA effectively thwarts any consideration of diversification by Illinois Power Company. Diversification by it under present law would by reason of the "unless and except" clause potentially expose Illinois Power Company to the revocation of its present exemption by the SEC. The consequence of this could be not only the requirement that Illinois Power Company divest its diversified non-utility properties, but also divest one of its utility properties, a risk that the Company cannot afford to take. Therefore, in the absence of an amendment to Section 3 of the PUHCA as discussed in your letter, Illinois Power Company is effectively precluded from considering diversification.

Responding to your second question under Approach Two, the proposed amendment to Section 3 would have no effect upon the regulatory jurisdiction of the Illinois Commerce Commission. Under the Illinois Public Utilities Act, the Commission has comprehensive jurisdiction to regulate every aspect of our utility business and, in my opinion, has effectively and actively exercised that jurisdiction throughout the years.

Overall, I would expect diversification to strengthen the Company's financial performance and this would, of course, directly and indirectly benefit our ratepayers and stockholders.

I cannot say now the extent to which Illinois Power Company would diversify or in the areas in which it might diversify if the amendment is enacted. In any event, Illinois Power Company would continue to be committed to the electric and gas utility business and our obligation to render those services would always have first call on our resources. We are keenly sensitive to the needs and problems of our customers. Any diversification by Illinois Power Company would most likely be in areas allied to our present electric and gas industries.

Again, I would like to express my appreciation for your interest in our industry.

Sincerely,

Charles W. Wells

C. W. Wells
Executive Vice President

cc: Michael V. Hasten, Chairman, Illinois Commerce Commission
George B. Pletsch, Schiff Hardin & Waite
Wendell J. Kelley

IOWA RESOURCES INC.
666 Grand Avenue/P.O. Box 657
Des Moines, Iowa 50303
(515)-281-2900

Dwight H. Swanson
Chairman and President

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November 18, 1981

The Honorable Tom Corcoran
1107 Longworth House Office Building
Washington, D.C. 20515

Dear Representative Corcoran:

Thank you for the opportunity to express our views regarding amendments to the Public Utility Holding Company Act of 1935. Iowa Resources Inc. was formed in 1979 as the holding company for Iowa Power and Light Company, an electric and gas utility serving customers in central and southwest Iowa. Iowa Resources is an exempt holding company pursuant to Section 3(a)(2) of PUHCA.

Iowa Resources favors the second approach outlined in your October 27 letter as the simpler, more beneficial approach to amending PUHCA to remove some of its unnecessary and outdated limitations on utility diversification. Specifically, it is our position that Section 3 of PUHCA should be amended, first, to exempt holding companies with only one public utility subsidiary, provided such subsidiary's operations are limited to its state of incorporation and contiguous states; second, to exempt holding companies created by companies that are presently exempt under Section 3(a)(2); and third, to remove the "unless and except" clause. Your inquiries about the impact of this approach, and our responses, are set forth below:

> Question 1: To what extent, if any, would this approach lead to utility diversification?
>
> It is our belief that adoption of the approach suggested above would substantially encourage utility diversification. Because Iowa Power operates in only one state, Iowa Resources was able to utilize the Section 3(a)(2) exemption and has established separate corporate subsidiaries for its utility and non-utility operations. However, many utilities that do not meet the current narrow exemption requirements of Section 3(a)(2) are unable to take even this first step towards diversification.
>
> Even as an exempt holding company, Iowa Resources is hindered in its diversification efforts by the "unless and except" clause, which allows the SEC to revoke the exemption if it determines the retention of such exemption to be "detrimental to the public interest or the interest of investors or consumers." Revocation of its exemption could subject Iowa Resources to (i) the forced divestiture of either its gas or electric business; (ii) the forced sale of its non-utility businesses; and (iii)

Operating subsidiaries: IOWA POWER AND LIGHT COMPANY • INDUSTRIES OF IOWA CORP.

the additional regulation imposed upon registered holding companies of PUHCA. Removal of the "unless and except" clause and the associated limitations which have been imposed on the ability of exempt public utility holding companies and their subsidiaries to conduct businesses not functionally related to their utility operations would further encourage utility diversification.

Question 2: How would enactment affect the state public utility commission and the utility's stockholders and ratepayers? In particular, to what extent, if any, would enactment lead to diversification?

We believe that enactment of the proposed amendments will allow utilities the opportunity to diversify if business and economic conditions warrant. Diversification is only one of several strategies available to utilities as a method for improving their overall financial performance. To the extent that such improved financial performance enhances the attractiveness of its securities, a utility's ratepayers may reap long-run benefits in the form of reduced costs of capital while its stockholders benefit from increased earnings.

We are in complete support of your efforts to remove federal statutory and regulatory barriers that may inhibit the ability of utilities to financially help themselves and their stockholders and ratepayers. If I may be of further assistance in your review of the Public Utility Holding Company Act, please do not hesitate to call me.

Sincerely,

DHS/KDH/js

MISSISSIPPI POWER & LIGHT COMPANY
Helping Build Mississippi
P. O. BOX 1640, JACKSON, MISSISSIPPI 39205

DONALD C. LUTKEN
PRESIDENT

November 18, 1981

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Honorable Tom Corcoran
United States Representative
1107 Longworth House Office Building
Washington, D. C. 20515

Dear Representative Corcoran

I share your interest in either amending or repealing the Public Utility Holding Company Act expressed in your letter of October 27, 1981. My clear preference is for repeal.

Rather than respond directly to your questionnaire, I am attaching a discussion memorandum which addresses the thrust of your questionnaire.

I view the Act as redundant and duplicative of other federal initiatives. It may have served a useful purpose in the 30's but it is hardly appropriate in today's real world.

If we can cut away the cumulative legislative and regulatory debris that frustrates sound, intelligent business practices we will have gone a long way toward restoring the health of our industry.

Thanks for your interest.

Sincerely

Donald

DCL:sb

Attachment

cc - System Chief Executive Officers - wo/attachment
System Public Affairs Committee - wo/attachment

DRAFT - 4/27/81

Repeal of the Public Utility Holding Company Act of 1935

The Public Utility Holding Company Act of 1935 ("PUHCA") is New Deal legislation that has served to remedy abuses accompanying the concentration of control over electric and gas utilities once exercised by a few large holding companies, operating in disparate parts of the nation during the early 30's without effective state regulation. In the view of Congress, the power and interstate character of these holding companies rendered state control over these abuses ineffective at that time and required that authority over them be conferred upon a federal agency, the Securities and Exchange Commission ("SEC" or "Commission"). The primary aim (and outcome) of the legislation, therefore, was to reorganize these holding companies into geographically contiguous units and thereby restore effective state control.

The PUHCA still imposes a series of federal controls on utility holding companies, their service and operating companies, and their other subsidiaries which are far broader and more comprehensive than those imposed upon any other industry. These controls fall into three broad categories: 1) registration of the holding company; 2) corporate simplication and geographical integration of holding companies; and 3) regulation of numerous business transactions.

Registration under the PUHCA is fairly similar to the filing of a registration statement under the Securities Act of

1933 ("33 Act"). Disclosure of information through a PUHCA filing is intended to assist the Commission in its regulatory task rather than to enlighten the investing public, and the Commission on its own initiative has required far more detailed information. L. Loss, Securities Regulation 134 n.12 (2d ed. _______). Beyond this initial disclosure obligation, the PUHCA is duplicative of certain important provisions of the Securities Exchange Act of 1934 ("34 Act") regulating the solicitation of proxies, imposing liability for insider trading, and depriving directors and officers of short swing profits. §§ 12(e), 11(g); § 17(a); § 17(b). Thus, in the securities area, the PUHCA is essentially a more elaborate and unnecessary recapitulation of other existing federal statutes.

The heart of the PUHCA when enacted in 1935 was the provision in section 11 that utility holding companies should undergo a simplificiation of their corporate and capital structures and should be geographically integrated. The pyramiding practiced during the early thirties by some holding companies created capital structures that, by their complexity, were viewed as defying regulation. This necessitated, as a first step, that the SEC undertake capital reorganizations, with the goal of ensuring that "the holding company system does not unduly or unnecessarily complicate the [corporate] structure, or unfairly or inequitably distribute voting power among security holders." § 11(b)(2). Standing alone, simplication of holding companies' capital and corporate structure was viewed as not sufficient to achieve the Act's basic goal of making the utility operating company more amenable to local control. In order to achieve this goal, Section 11(b)(1) empowered the Commission to reorganize public utility systems, with the goal of limiting them to "a single integrated public utility system" operating in a single geographic area or region. In many instances, these reorganizations required holding companies to divest themselves of geographically diverse companies. In only two situations did the Act provide for exceptions. A holding company could retain an additional integrated utility system if the company could demonstrate to the satisfaction of the SEC that the additional system was necessary economically and would not impair localized management or the effectiveness of regulation. § 11(b)(1). Second, the holding company could also retain other businesses which "are reasonably incidental, or economically necessary or appropriate." With these two limited exceptions, however, the PUHCA was intended to, and has created streamlined and geographically unitary utility systems and has thus accomplished its purpose.

The third, currently active area of pervasive federal control is the present regulation of a utility company's business transactions. Before a holding company or its subsidiaries may acquire any securities, utility assets, or other interest in any business, the company must submit detailed financial information to the SEC and must obtain its approval. § 9(a)(1), § 10(a)(1). The SEC can refuse its approval whenever the acquisition tends toward interlocking relations or concentration of control, unduly complicates the capital structure of the holding company, or specifies consideration, including fees and commissions, which is unreasonable. § 10(b). This, in essence, gives the SEC veto power over a utility's diversification efforts which have also received any necessary approval of state regulatory commissions. This authority has impeded the efficient and economic development of utility companies under the act and has been responsible in part for turning the utility holding company industry into the backward cousin of the energy sector.

Beside these controls on external ventures, the PUHCA also provides for surveillance and regulation of internal operating practices. Section 13(a) expressly forbids a holding company from entering any sales, service, or construction contract with its subsidiaries for a charge. Subsidiaries of holding companies and mutual service companies, on the other hand, are permitted to perform such contracts for associated companies but only if the SEC determines that the charge for the work is "at cost, fairly and equitably allocated." § 13(b). This constraint does not apply to any other sector of the electric utility industry. This unduly burdens companies presently under the act. SEC regulation permeates the utility holding company business far beyond this scrutiny of individual contracts. The PUHCA also authorizes the SEC to regulate or, in some cases, to prohibit intercompany loans, dividend payments, capital contributions, political contributions, and lobbying activities. §§ 12(a)-(d), (h), (i).

In order to maintain this strict federal control over virtually every aspect of a holding company utility's operations, the SEC has the authority to institute numerous recording and reporting requirments that in many instances duplicate requirements of states and the Federal Energy Regulatory Commission (FERC). The SEC may prescribe the proper form and manner for keeping accounts, correspondence, memoranda, papers, and other records. §§ 15(f)-(h). The Commission also may require holding companies and mutual service companies to file annual, quarterly, and special reports on their financial condition, security structure, and assets. § 14. Together, these various requirements entangle utility operating companies in vast amounts of unnecessary and duplicative paperwork, that both FERC and State Public Service Commissions now also require.

As has been recently recognized, the time has come to evaluate whether there is a continuing need for the federal regulation of utilities established by the PUHCA. General Accounting Office, "The Force of the Public Utility Holding Company Act Has Been Greatly Reduced by Changes in the Securities and Exchange Commission's Enforcement Policies," 17 (June 20, 1977). It seems incontrovertible that the main purposes of the Act have been accomplished and that the few necessary remaining controls can be equally well-exercised by state utility and security commissions.

According to the GAO, the major goal of PUHCA -- simplification of holding companies' corporate structures and the confinement of the companies to specific geographic areas -- has long since been achieved. GAO Report, p. 6. See also L. Loss, Securities Regulation 2276 (2d ed. Supp. __). As a result of this process, the holding companies and their operating utilities are now amenable to effective state and local control. Given this change in reality effected by the Act, and active state agencies, it is clear that utility holding company regulation should not be duplicated with both state and federal agencies.

Secondly, in the area of securities regulation, the elaborate process of utility registration and the rules concerning insider trading and proxy solicitation afford no greater protection than the '33 Act, the '34 Act, and state securities' laws. They are essentially duplicative and can be repealed.

Thirdly, in the area of a utility's other business dealings, the state utility commisions are perfectly capable, under well-developed principles of regulatory law, to police both outside acquisitions and intrasystem transactions. State public utility commissions and FERC are competent in investigating whether a utility's acquisition of diverse businesses is likely to endanger the reliability of service, and these commissions are now vigilant to disallow costs charged by associated companies or any other contractor which are not in the public interest. Thus, the states are at least as capable of exercising the remaining powers granted by the PUHCA as the small staff at the SEC.

Repeal would also serve to remove disincentives to entry into the electric generating business by other industries, and to remove some restraints on joint generating projects by non-holding-company utilities.

In summary, repeal of the PUHCA would serve to free the utility industry from an unnecessary and unproductive duplicative layer of federal regulation, and to limit control of utilities' activities to the appropriate level of government: state and local utility commissions.

Duquesne Light Company 435 Sixth Avenue
Pittsburgh, Pennsylvania
15219

JOHN M. ARTHUR
Chairman of the Board and
Chief Executive Officer

November 18, 1981

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The Honorable Tom Corcoran
1107 Longworth House Office Building
Washington, D.C. 20515

Dear Representative Corcoran:

This is in response to your letter of October 27 requesting comments from the perspective of an independent operating company on the two approaches for amendment of the Public Utility Holding Company Act set forth in the discussion paper enclosed with your letter.

Duquesne recognizes that the existing structure of the Public Utility Holding Company Act presents substantial obstacles to an independent electric utility considering diversification into non-utility enterprises. We also recognize that the Act provides substantial limitations on the activities of registered holding companies. With today's high level of scrutiny of electric utility rates, operations and accounting during lengthy rate proceedings, either at the State or Federal level, and often both, I question whether the Public Utility Holding Company Act is any longer necessary for protection of customer's interests.

Indeed, there appears to be some basis for concern that in today's restrictive regulatory climate the Act may very well work to the detriment of customer's interests. Faced with today's high cost of new capital, repeal of the Act may prove a possible way for utilities to improve their financial conditions and thereby attract new capital at more favorable rates.

We can agree that most electric utilities are facing difficult financial problems and that restrictive governmental regulation has played a large part in creating such conditions. While such regulation may serve short term interests to minimize electric rate increases, we must recognize that keeping the price of electric too low for too long will ultimately result in shortages of supply, with attendant social and economic consequences, and higher ultimate costs in the future for electric service.

From Duquesne's perspective, we cannot say that we would favor Approach One or Approach Two set forth in your discussion paper as both approaches have merit. Although Duquesne is not a part of a holding company system, we do not believe that Federal or state legislation should preclude any electric company from making decisions related to diversification which are in the best interests of the public, its shareholders and its customers.

We wish to thank you for your recognition and concern for the serious financial problems faced by the electric utility industry and encourage you to fully explore with all responsible interest groups the possible benefits from amendment or repeal of the Public Utility Holding Company Act.

Sincerely yours,

John M Arthur

minnesota power / 30 west superior street / duluth, minnesota 55802 / telephone 218-723-3991

John F. McGrath - senior vice president, general counsel and secretary

November 12, 1981

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The Honorable Tom Corcoran
Congress of the United States
House of Representatives
Washington, D. C. 20515

Sir:

Thank you very much for your letter regarding modification of the Public Utility Holding Company Act. Your letter to Mr. Rowe has been referred to me for response because I have been working on this problem.

We heartily support Approach No. 2 as set forth in your letter for amending the Holding Company Act. The adoption of that approach would, in our judgment, permit public utilities to diversify into areas which are not necessarily "functionally related" to the utility business. It is our opinion that there are areas in which utilities could diversify and enhance the earnings of the company to the betterment of the shareholders and, by strengthening its financial position, enhance the reliability of service to ratepayers. Stable and financially solvent, utilities would be in a position to continue supplying service at reasonable rates. Without such an amendment, the utility companies are restrained from diversifying into many areas through fear of losing their exemption particularly because of the "unless and except" clause of Section 3 of the present Act.

We sincerely appreciate your interest in this matter. I urge your support of legislation which will amend the Act in accordance with Approach No. 2 as set forth in your communication.

Very truly yours,

John F. McGrath

John F. McGrath

JFMcG:es

NORTHEAST UTILITIES
NU
THE CONNECTICUT LIGHT AND POWER COMPANY
THE HARTFORD ELECTRIC LIGHT COMPANY
WESTERN MASSACHUSETTS ELECTRIC COMPANY
HOLYOKE WATER POWER COMPANY
NORTHEAST UTILITIES SERVICE COMPANY
NORTHEAST NUCLEAR ENERGY COMPANY

P. O. BOX 270
HARTFORD, CONNECTICUT 06101
(203) 666-6911

WALTER F. TORRANCE, JR.
SENIOR VICE PRESIDENT AND GENERAL COUNSEL

November 13, 1981

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The Honorable Tom Corcoran
Congress of the United States
House of Representatives
Washington, D.C. 20515

Dear Congressman Corcoran:

Northeast Utilities is pleased to respond to your letter of October 27 asking our views on the Public Utility Holding Company Act of 1935. Lee Sillin, to whom your letter is addressed, is presently away, and I am responding to your inquiry on his behalf.

As you may be aware, the Northeast Utilities system is a registered holding company system subject to regulation under PUHCA and is one of less than 15 such registered systems. We provide electric and gas service in Connecticut and electric service in western Massachusetts.

We reviewed the two approaches to PUHCA covered in the discussion paper with your letter. Approach Two deals with the status of public utility holding company systems which are exempt from registration under PUHCA. Since this is not our status, our comments which follow are focused on Approach One.

Our response to the five questions on Approach One is as follows:

Question 1. The problems of size and structural completeness which PUHCA was intended to correct have, in our judgment, been corrected for all of the remaining registered holding company systems. For example, our holding company structure is typically simple and lacking in complexity, with a non-operating holding company and four principal operating subsidiaries, each of which is a direct subsidiary of the holding company.

Our service area is confined to two states.

Question 2. In our judgment, the existing state regulations should adequately protect the interests of stockholders and ratepayers if PUHCA were to be repealed. This is clearly so in the financing area in which the bulk of SEC's current activity is concentrated.

However, we are not satisfied at this point that complete repeal is necessary. It may well be more appropriate at this time simply to modify some of the outdated provisions of PUHCA to lighten regulatory burdens and eliminate duplication. In particular, we would urge modifications that would amend PUHCA to open the way for diversification, permit us greater flexibility in our financing with a lighter regulatory burden and ease some of the rules on intercompany transactions. In addition, we have a special problem because of the PUHCA mandate that we dispose of our gas properties, despite the adverse impact that this would have both on our customers and our shareholders.

Question 3. In our judgment, it is unlikely that repeal of PUHCA would result in conflicting state regulations.

Question 4. So far as public confidence in the state commissions is concerned, it is important to recognize that public focus in the states has been on rate regulation, an area in which the SEC under PUHCA plays no role. In the areas where the state commissions provide regulation that is duplicated by what the SEC does under PUHCA, such as the financing area, the diversification area and the area of intercompany transactions, there appears to be no lack of public confidence in the state commissions. Thus, repeal of PUHCA, or a loosening of regulation in these areas, should cause no significant change in local regulation, at least in Connecticut and Massachusetts, and I see no reason why the public should have any less confidence in the performance of the state commissions in these areas.

Question 5. In our opinion, repeal of PUHCA, or its modification in the areas that I have suggested above, should have no significant adverse effect on our state commissions, ratepayers, utility companies or their shareholders. The action would clearly be beneficial to our companies and to our shareholders in reducing regulatory burden and thereby facilitating more effective management. So far as diversification is concerned, we believe that this could be beneficial both to us and our shareholders and to our ratepayers.

Again, I would like to thank you for the opportunity to respond to your letter. We expect to be actively involved in any legislative effort to repeal or modify PUHCA.

Very truly yours,

Walter F. Torrance, Jr.

Senior Vice President
and General Counsel

WFT.JR:JES

MONTANA·DAKOTA UTILITIES CO.

400 NORTH FOURTH STREET · BISMARCK, ND 58501 · TEL. (701) 222-7900

November 13, 1981

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The Honorable Tom Corcoran
Representative in Congress
Congress of United States
House of Representatives
1107 Longworth House Office Building
Washington, DC 20515

Dear Congressman Corcoran:

Thank you for your letter of October 27, 1981. I share your concern regarding the financial plight of the utility industry, and am pleased that you, as a lawmaker, are reviewing this matter.

I agree with you that although there are many factors which contribute to the depressed economic outlook of the utility industry, these factors presently are basically a matter of state law; however, there is one Federal law, the Public Utility Holding Company Act of 1935 which does affect the organization of the utility industry, which in turn, does have an effect on the financial status of the industry as a whole.

Upon reviewing your approaches, I do not feel that it is necessary to completely repeal the Public Utility Holding Company Act of 1935; and therefore, I endorse Approach No. Two as outlined by you, which involves (1) an amendment to the Act creating a new exemption for holding companies that have only one subsidiary public utility company and which does business only in the state in which it is organized and states contiguous thereto; and (2) to provide that the exemption contained in Section 3 of the Act, as amended, shall be unconditional and thus not subject to review by the Securities and Exchange Commission.

I believe this approach would leave the 1935 Act basically in tact, but would permit, on a very limited basis, creation of a holding company involving a public utility, if that utility limited its utility activities to the state in which it is incorporated or in states contiguous thereto. I also wholeheartedly endorse the second portion of your approach regarding the unconditional exemption. As you know, under the existing law, the exemption contained therein, is not unconditional, and thus a Company could be forced to divest either its electric or gas business if it is a combined company, and could be forced to sell a non-utility business. Because of this risk, most utility companies heretofor have not sought an exemption.

If I or my staff can be of any assistance to you or furnish any information which will assist you in your review of this matter, please contact me at any time.

Sincerely,

J. A. Schuchart
President and Chief
Executive Officer

nf

BANGOR HYDRO-ELECTRIC COMPANY
ELECTRIC LIGHT AND POWER PUBLIC SERVICE SERVING EASTERN MAINE

33 State Street, P.O. Box 932, Bangor, Maine 04401 Tel. 207-945-5621

al

November 10, 1981

Hon. Tom Corcoran
Representative in Congress
1107 Longworth House Office Building
Washington, DC 20515

Re: Public Utility Holding Company Act of 1935

Dear Rep. Corcoran:

Your letter of October 27 to Mr. Haskell has been forwarded to me for reply.

Bangor Hydro is only incidentally a "holding company" which must seek exemption under the Holding Company Act. This occurs as a result of a minority equity interest (about 14%) in a transmission company here in Maine. Accordingly, other than reviewing the exemption request each year and paying the fee, we have no experience under the Act.

However, like other utilities we are looking at the possibility of diversification or reorganization in order to adjust to present and future challenges. We would pursue these steps if we determine that they are necessary or desirable in order to better accomplish our business as a public utility. We think there is a fundamental distinction between this sort of diversification, and diversification in response to a perceived adverse regulatory climate or in hopes of augmenting poor utility financial results.

Given this framework, we consider the Act to be of minimal concern. However, to the extent the Act limits our ability to accomplish what we otherwise may determine to be best for the Company, its ratepayers and its stockholders, we think it should be changed.

However, I am not sure how one would draft a statute that could differentiate between those companies that are diversifying or reorganizing in order to support the basic public utility business, and those that are taking such steps in order to branch away from the public utility business. Arguably the latter ought to be subject to at least some of the oversight which the Act seeks to provide.

I hope these general comments are of some assistance.

Very truly yours,

Robert S. Briggs, Esq.
Vice President and General Counsel

RSB:p

VIRGINIA ELECTRIC AND POWER COMPANY
RICHMOND, VIRGINIA 23261

T. JUSTIN MOORE, JR.
CHAIRMAN OF THE BOARD
AND
CHIEF EXECUTIVE OFFICER

November 9, 1981

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The Honorable Thomas Corcoran
U. S. House of Representatives
House Office Building
Washington, D. C. 20515

Dear Congressman Cocoran:

Thank you for your letter of October 27, 1981 requesting our comments on the Public Utility Holding Company Act of 1935 (PUHCA).

As an independent operating public utility not currently subject to the PUHCA, the primary impact the Act has had on my Company over the years has been to impose restraints on the decision making process whenever any activity was contemplated which would have required a change in corporate structure that might have threatened our Company becoming a Regulated Holding Company under the PUHCA.

It has been our opinion that the regulatory burdens under the Act so inhibited financing flexibility and organizational and operational prerogatives that any activity which could cause the Company to be regulated under the Act should be avoided.

As you note in your letter, the principal interest in amending the Act comes from the belief that public utilities are restricted by the Act from diversification activities which might, if successful, allow utilities to improve their earnings through less regulated activities and thereby improve the financial condition of the regulated business.

In response to your October 27, 1981 position paper questions, we have the following answers:

> Either approach would be an improvement over the current situation and would allow freedom to consider diversification through the Holding Company structure.

Approach One

Question 1 - A company such as ours does not present any problems contemplated by the Act. Hence, the reason that the present Section 3 exemptions were written into the Act.

Question 2 - In our case current state statutes duplicate the protection for which the Act was designed.

Question 3 - No

Question 4 - In our opinion, the answer is yes.

Question 5 - Repeal would allow the consideration by this Company of diversification opportunities under a Holding Company structure.

Approach Two.

Question 1 - This approach would also allow our Company to consider diversification using the Holding Company structure, although there would be somewhat less flexibility than under Approach One.

Question 2 - Enactment would place more authority in the hands of State PUC's; stockholders return opportunities would improve; ratepayers would not be affected until a diversification investment was made. A successful diversification investment would lower the cost of equity capital and the overall cost of capital thereby lowering future revenue requirements for the entire enterprise. The converse would occur with an unsuccussful diversification attempt if the size of the investment were material.

The opportunity exists in varying degrees for every other industry in the United States to diversify its risk in order to avoid or shelter its primary business from periods of business distress. Why should the electric utilities be denied this opportunity?

Thank you for the opportunity to comment on your worthwhile legislative activity.

Yours very truly,

T. Justin Moore, Jr.

Commonwealth Edison
One First National Plaza, Chicago, Illinois
Address Reply to: Post Office Box 767
Chicago, Illinois 60690

Tom —

Good reply

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DAN'S NOTES:

November 6, 1981

Honorable Tom Corcoran
1107 Longworth House Office
Building
Washington, D. C. 20515

Dear Tom:

Thank you for your October 27 letter concerning the Public Utility Holding Company Act. You noted that concern is growing about the financial plight of the utility industry. It is unfortunate, and harmful to our national interest, for the electric utility industry to be in its present financial plight. The fact that many persons outside the industry, including regulators and legislators, are recognizing the industry's financial problems and becoming concerned about them is encouraging and, I hope, offers the chance to do something about the situation.

You asked whether changes to the Public Utility Holding Company Act, or its outright repeal, could help the industry's financial condition without compromising the public interest. In general, I believe that the Holding Company Act has outlived its usefulness. The combined regulatory spheres of state public service commissions, the Federal Energy Regulatory Commission, and the Securities Exchange Commission under the Securities Act and Securities Exchange Act are adequate to protect investors and customers from the kinds of concerns which led to the passage of the Act during the Depression. The FERC regulates wholesale power transactions among the members of holding company systems. State commissions carefully monitor utility security sales as, of course, does the SEC. State commissions are also much more sophisticated in analyzing and regulating sales of goods and services within families of associated companies than they were 50 years ago.

You asked whether repeal of the Public Utility Holding Company Act would result in conflicting state regulation and whether there is adequate public confidence in state public service commissions to reduce the federal role in regulation of local utilities. Since we are, for all practical intents and purposes, regulated by only one state public service commission, I am not in a position to say much about the possibilities of conflict. My impression, however, is that the Holding Company Act does not serve to limit conflicting state regulation and that repeal of the Act would not promote conflict. Regarding your second question, I do think the public has confidence in state regulatory commissions. To the extent there is not public confidence, the solution lies in improving the quality of the state commissions, not in more federal regulation. Finally, you asked what effect repeal of the Holding Company Act would have in Illinois. I think the effect would be quite small, at least as far as electric utilities are concerned. None of the electric utilities in this state is now part of a registered holding company system and, particularly in view of the Peoples Gas situation, I am sure that the Illinois Commerce Commission would consider any plan to form a holding company very carefully.

As an alternative to outright repeal of the Public Utility Holding Company Act, you asked about an amendment which would expand certain of the exemptions currently available under the Act. If the Act is not repealed, I believe that such an amendment would be an excellent idea. It would allow companies like ours greater freedom to clearly separate their utility and non-utility businesses. You asked whether this would lead to greater diversification by utilities. In some cases it might, where the utility is in a financial position to diversify advantageously. I think, however, that the greatest impact would not be to encourage diversification, a good part of which is already permissible for a company like ours, but to separate utility and non-utility operations. Such separation is fair to both investors and ratepayers. If a non-utility enterprise is unsuccessful, the utility's customers will be insulated from the impact. On the other hand, if a non-utility business is successful, there will be less pressure on regulators to unfairly appropriate for the utility customers benefits which properly belong to the stockholder.

I hope my response has been of some help to you. Please let me know if I can do anything further.

Sincerely,

James J. O'Connor
Chairman and President

KANSAS CITY POWER & LIGHT COMPANY
1330 BALTIMORE AVENUE
P. O. BOX 679
KANSAS CITY, MISSOURI 64141

SAMUEL P. COWLEY
VICE PRESIDENT AND SECRETARY

November 6, 1981

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DAN'S NOTES:

Hon. Tom Corcoran
House of Representatives
1107 Longworth House Office Building
Washington, D. C. 20515

Dear Mr. Corcoran:

This will respond to your letter to Arthur J. Doyle, Chief Executive Officer of Kansas City Power & Light Company regarding the Public Utility Holding Company Act.

Our Company is not now a holding company and we presently have no plans to become one nor do we have any intentions at this time to diversify to the point that the Holding Company Act would cause us a problem. We are not in a position to provide any significant input to your survey of utility companies on the proposed legislation. However, we are interested in and do expect to follow the Utility Holding Act legislation.

Sincerely yours,

spc-rb

PUBLIC SERVICE COMPANY OF OKLAHOMA
A CENTRAL AND SOUTH WEST COMPANY

P.O. BOX 201 / TULSA, OKLAHOMA 74102 / (918) 583-3611

BOOTH MOFFETT
VICE PRESIDENT, PUBLIC AFFAIRS

PSO

November 5, 1981

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The Honorable Tom Corcoran
U. S. House of Representatives
1107 Longworth House Office Building
Washington, D. C. 20515

Dear Mr. Corcoran:

Your letter of October 27, 1981, addressed to Mr. Fate has been forwarded to me for reply. Mr. Fate is on leave for several months and his correspondence is being handled by others.

Public Service Company of Oklahoma is a wholly owned subsidiary of Central and South West Corporation and as such could not respond as "an independent operating company."

Should you like us as a subsidiary to address your legislative approaches, we would be pleased to respond.

Very truly yours,

EBM:ed
cc: M. E. Fate

TV

CHARLES B. FINCH
President

DATE ANS: DOC #
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F.
DAN'S NOTES.

Allegheny Power System, Inc.
320 Park Avenue, New York, N.Y. 10022 (212) 752-2121

Principal Subsidiaries:
Monongahela Power Company
The Potomac Edison Company
West Penn Power Company

November 2, 1981

Hon. Tom Corcoran
United States House of Representatives
1107 Longworth House Office Building
Washington, D. C. 20515

Dear Congressman Corcoran:

Thank you for your letter of October 27, 1981.

In our judgment neither the repeal nor amendment of the Public Utility Holding Company Act would affect the financial plight of the utility industry. That plight is a direct result of the failure of state regulatory commissions to price electricity at its true cost, including the cost of the very large amounts of capital needed to build environmentally acceptable generation, transmission, and distribution facilities.

You ask particularly about diversification. I am told by our counsel that the Securities and Exchange Commission has authority under the Holding Company Act to permit the kind of diversification that most utilities are talking about. But the main point about diversification is that it is not a substitute for bad regulation. It will not help the financial plight of utilities and might well end up adversely affecting the quality of their service.

Sincerely yours,

Charles B. Finch

CBF:bg

P.S. My recollection is that your namesake was one of the originators of the Holding Company Act.

11/[illegible]/81 [illegible] Our first
response

RESPONSES FROM PUBLIC UTILITY COMMISSIONS

ARKANSAS
PUBLIC SERVICE COMMISSION
P.O. Box C-400
Markham & Victory Streets
LITTLE ROCK 72203

N.M. Norton, Jr
Chairman
Sandra W. Cherry
Commissioner
Walter Skelton
Commissioner

February 1, 1982

Tom Corcoran
Representative in Congress
1107 Longworth House Office Building
Washington, D.C. 20515

Dear Representative Corcoran:

Thank you for your letter of December 23 relaying the changes you proposed to the Public Utility Holding Company Act in the form of H.R. 5220, the Public Utility Financial Reform Act. As you noted such legislation is of interest not only to me but to all those who serve the public through utility regulation.

Of particular interest to this Commission is the diversification by utilities into non-utility areas of investment in order to solve their current financial predicaments. This might not only aid the utility but alleviate some of the burden now being placed upon the ratepayer as well, in the long run.

Please keep me apprised of the status of H.R. 5220 and do not hesitate to call upon me in the future. I look forward to hearing from you.

Sincerely,

N. M. Norton, Jr.

State of Florida

Joseph P. Cresse
Chairman

FLETCHER BUILDING
101 EAST GAINES STREET
TALLAHASSEE 32301
(904) 488-2986

Public Service Commission

January 14, 1982

See [illegible] Dec. 4, 1981

Honorable Tom Corcoran
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Thank you for sending along the information concerning HB 5220, your bill to amend the Public Utility Holding Company Act (PUHCA).

This Commission shares your desire to enhance the financial health of electric and gas utility companies and is in agreement that the problems which gave rise to PUHCA in the 1930's are not likely to recur. We are in favor of allowing utility companies to diversify so long as the issue of cross-subsidization between parent and subsidiary can be effectively addressed. The appropriate allocation of risk between stockholders and ratepayers is of primary concern to the Commission and we would favor measures to allow state regulatory authorities access to information held by the non-regulated entity for this purpose.

The opportunity to comment on your well-reasoned proposal is greatly appreciated. Feel free to call on us for any further assistance we can provide.

Sincerely,

Joe Cresse

Joseph P. Cresse

JPC:CLS:brf

al

State of Florida

Joseph P. Cresse
Chairman

FLETCHER BUILDING
101 EAST GAINES STREET
TALLAHASSEE 32301
(904) 488-2986

Public Service Commission

December 4, 1981

See [illegible] 4, 1982

The Honorable Tom Corcoran,
Representative
House of Representatives
1107 Longworth House Office Building
Washington, D.C. 20515

Dear Representative Corcoran:

Thank you very much for your letter of October 27, 1981. The request for information that you have made is of a highly complex nature. I am having staff prepare a response to your inquiry. Particularly, I have asked them to address both the legal and the technical impact of the repeal of the Public Utility Holding Company's Act of 1935.

In this regard, they will analyze both approach one and two you propounded in your request. I hope that this delay will not endanger your legislative effort.

Sincerely yours,

Joe Cresse

Joseph P. Cresse
CHAIRMAN

JPC:WSB:ahw

JOHN SPELLMAN
Governor

STATE OF WASHINGTON
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION
Highways-Licenses Building • Olympia, Washington 98504 • (206) 753-6423 • (SCAN) 234-6423

January 11, 1982

The Honorable Tom Corcoran
Member of Congress
1107 Longworth House Office Building
Washington, D. C. 20515

Dear Congressman Corcoran:

Thank you for sending us copies of information concerning H.R. 5220, the "Public Utility Financial Reform Act."

There are no registered holding companies which operate in the State of Washington. We do have some companies which operate under PUHCA exemptions. The state derives some benefit from the exempt status of those holding companies because SEC review of capitalization is still required for exempt companies. Since we only regulate the operations of the utility subsidiaries it is helpful to have review of the complete holding company capitalization by another agency.

Therefore, we would urge the continuation of that review function in the revisions to the holding company act. Beyond that we certainly commend your efforts to improve this legislation and eliminate unnecessary regulatory burden.

Thank you for providing us an opportunity to comment on the proposal.

Sincerely,

Robert W. Bratton
Chairman

RWB:dd

cc: NARUC

STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS

PUBLIC UTILITIES COMMISSION
100 Orange Street
Providence, R. I. 02903

January 4, 1982

The Honorable Tom Corcoran
House of Representatives
1107 Longworth House Office Building
Washington, D. C. 20515

Dear Representative Corcoran:

Thank you for enclosing in your letter of December 23, 1981, a copy of H.R. 5220, the "Public Utility Financial Refort Act."

Please be advised that the National Association of Regulatory Utility Commissioners has established a special committee which is investigating the entire issue of public utilities diversification, and I will specifically instruct them to review your enclosed legislation.

In the meantime I am referring to you a copy of the speech delivered by Rhode Island's Governor J. Joseph Garrahy at a recent convention of NARUC. I call your attention specifically to those portions of his speech which deal with the subject of the Public Utilities Company Holding Act of 1935 and the extreme care that must be taken relative to amendments to the Act. I fully share Governor Garrahy's views.

Sincerely,

Edward F. Burke

Edward F. Burke
Chairman

EFB:lls
Enclosure

cc: Mr. Paul Rodgers, NARUC
The Honorable Stanley York, Chairman
Wisconsin Public Utilities Commission

PUBLIC SERVICE COMMISSION
STATE OF NEVADA

(2)

Address all communications to the Commission
Telephone (702) 885-4180

KINKEAD BUILDING
505 E. KING STREET
CARSON CITY, NEVADA 89710

January 6, 1982

Honorable Tom Corcoran
Representative in Congress
Congress of the United States
House of Representatives
Washington, D.C. 20515

Dear Tom:

I appreciate your recognition of the financial plight of the nation's public utilities and their ability in the future to meet the energy demands of the American public. It is satisfying to know that there are members of Congress who are attuned to this reality.

Concerning your amendment to Section 3 of the Public Utility Holding Company Act; it must be recognized that some type of realistic financial relief is needed for the nation's utilities, and at the same time keeping in mind their ability and flexibility in providing viable energy resources. It is evident that you address this exact situation with the concern of investors and consumers (ratepayers) in mind. Your amendment, as I read it, adequately protects against cross-subsidization between the utility business and non-utility business, when entering into diversification.

From my point of view, that of Financial Analyst for the Public Service Commission of Nevada, this type of legislation, as you have addressed it, is of vital concern to affordable and available energy for consumers. Finally, it is a step in providing the public utilities the opportunity to earn a realistic rate of return needed in order to attract investors' capital into the industry.

Thank you again for your efforts in Congress.

Sincerely,

PUBLIC SERVICE COMMISSION OF NEVADA

STEVE RIGAZIO
Financial Analyst

IOWA STATE COMMERCE COMMISSION

LUCAS BUILDING
DES MOINES, IOWA 50319

Commissioners:
Andrew Varley
Fred H. Moore
Christine A. Hansen
Executive Secretary
Robert G. Holetz

December 14, 1981

The Honorable Tom Corcoran
Congress of the United States
House of Representatives
1107 Longworth House Office Building
Washington, D.C. 20515

RE: Letter of October 27, 1981, concerning the Public Utility Holding Company Act

Dear Representative Corcoran:

Thank you for your above-referenced letter of October 27, 1981. Our staff is presently reviewing this matter in anticipation of some type of Public Utility Holding Company Act legislation. We believe existing law provides important protection to consumers and we would discourage repeal at the federal level.

We welcome the opportunity to submit comments to your Subcommittee once legislation concerning this subject matter has actually been introduced and we have the opportunity to evaluate specific proposals.

Thank you for your time and consideration.

Very truly yours,

Andrew Varley

Andrew Varley
Chairman

BS:lks

STATE OF CONNECTICUT
DEPARTMENT OF PUBLIC UTILITY CONTROL

December 9, 1981

DATE ANS: DOC
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DAN'S NOTES:

The Honorable Tom Corcoran
Congress of the United States
House of Representatives
Washington, D. C. 20515

Dear Representative Corcoran:

I am responding to your recent letter on revisions to our appeal of the Public Utility Holding Company Act with some very preliminary observations. Should specific proposals or draft legislation be formulated, our agency would be able to provide you with a more careful analysis and a reasoned evaluation.

Based on the limited information provided, however, we would offer the following comments:

APPROACH ONE

Question 1: The problems of size and structural complexity of utility companies organized under a holding company have increased in proportion to the increased complexity of corporate finances and to the increased complexity of the national energy picture.

The appropriate question in regard to a proposed repeal of the PUHCA is to what extent the current size and structural complexity of utility company organizations would increase without the PUHCA. While any answer to that question would be speculative, it is probable that the size and complexity of utility company organizations would increase exponentially.

Question 2: State law could not adequately protect stockholders and ratepayers from the problems addressed by the PUHCA because that Act was specifically aimed at holding companies which exploited the interstate character of their operations to defeat state regulation.

Question 3: Conflicting state regulation would most probably follow repeal of the PUHCA because today's climate of rising

1 Central Park Plaza - New Britain, Connecticut 06051
An Equal Opportunity Employer

energy costs and falling energy supply would lead each state to be overly protective of its interests.

Question 4: Public confidence in state PUC regulation means little if the state is powerless to protect its citizens from interstate abuses.

Question 5: If diversification means a single unregulated corporate structure entering into more than one energy supply field, then diversification means increased consolidation and monopolization which, traditionally, have been contrary to the public interest. This type of diversification could increase without the PUHCA.

APPROACH TWO:

Question 1: This approach could lead to the diversification outlined in the answer to Approach 1, Question 5. The fact that a holding company's subsidiaries were limited in operation to the state of incorporation and contiguous states would not significantly ease the problems arising from the interstate nature of the holding company's business. A blanket exemption from the PUHCA for such operations could invite abuses to the public interest.

Question 2: The same answer to Approach 1, Question 5 is applicable here.

I hope these comments are helpful to you, and that you will give us the opportunity to comment again should a specific proposal be drafted.

Very truly yours,

Thomas H. Fitzpatrick
Chairperson

THF:jh

STATE OF ILLINOIS
Illinois Commerce Commission

MICHAEL V. HASTEN
CHAIRMAN

160 NORTH LA SALLE STREET
CHICAGO, ILLINOIS 60601

December 7, 1981

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DAN'S NOTES: af

The Honorable Tom Corcoran
Member of the United States Congress
1107 Longworth House Office Building
Washington, D. C. 20515

Dear Congressman Corcoran:

Thank you for the opportunity to comment on the current legislative initiatives involving repeal or amendment of the Public Utility Holding Company Act of 1935 (PUHCA). I share your concern over the short and long term financial condition of the electric utility industry on a national basis. The maintenance of the integrity of the financial condition of utilities is and should be for the benefit of utility investors as well as ratepayers, current and future, who will require utility service from companies which are able to provide it at the lowest possible cost. However, the legislative initiatives which may result in the repeal or significant amendment of the PUHCA raise concerns regarding the clear and unequivocal need to protect investors and ratepayers from holding company abuses.

The passage of the PUHCA in 1935 was largely precipitated by blatant abuses at that time, and it is my opinion that that Act has served the public well in providing Congressionally mandated protection. If only because state public utility commissions generally lack both jurisdictional authority and resources to deal effectively with multistate holding companies, I would not favor repeal of the Act. Further, the Securities and Exchange Commission (SEC) has served the public well through its evenhanded approach to the implementation and enforcement of PUHCA, and it is doubtful that these functions can be absorbed by the many states which have holding companies subject to the Act.

Collaterally, the issue of utility diversification is currently much in vogue. Although I personally have no bias for or against diversification, I have, as an economic regulator, serious concerns about unbridled, unregulated diversification which, if left unchecked, could inure to the detriment of not only current and future investors, but also ratepayers of public utilities. I think it necessary that regulators have the tools available to them to be sure, when they examine such proposals, that diversification plans have sufficient safeguards to protect ratepayers and investors from abuse.

It appears that the organization of a holding company by a utility for the purpose of diversification through a non-utility subsidiary may be a device to avoid state regulation altogether. This is dangerous and clearly not in the public interest. Proposed amendments to Section 3 of the Act would eliminate Federal restraints as well from such a holding company. Since these amendments do not appear to be founded on public interest arguments, I cannot support their enactment. Moreover, I would be significantly dismayed to find the United States Congress an instrument in this effort to escape state regulation.

Finally, it is my understanding that the PUHCA now provides the SEC with adequate discretionary authority in its implementation to accomodate the changing size and structural complexity of the electric utility industry.

I think it interesting to note that some are arguing that the PUHCA is superfluous. That argument strikes me as significant in itself to support the Act's effectiveness and the need for its continued existence without significant amendment.

If I can be of any further assistance to you or if you are in need of any other information on the subject, please do not hesitate to contact me at your convenience.

Very truly yours,

Michael V. Hasten
Chairman

MVH/rn

DEC 7 1981

COMMISSIONERS:
FORD B. SPINKS, CHAIRMAN
MAC BARBER, VICE CHAIRMAN
JIM HAMMOCK
BILLY LOVETT
ROBERT C.(BOBBY) PAFFORD

HUGH S. JORDAN, SECRETARY

Georgia Public Service Commission
244 WASHINGTON STREET, S.W.
ATLANTA, GEORGIA 30334

December 3, 1981

The Honorable Tom Corcoran
Representative in Congress
Illionis Office
205 North Lake Street
Aurora, Illinois 60506

Dear Representative Corcoran:

Please excuse the delay in my response to your letter received November 6, 1981.

The PUHCA has had little direct effect upon State regulation in Georgia since it primarily prohibits and restricts activities of holding companies. Therefore, repeal would have little effect on State regulation. We have successfully regulated telephone holding companies and their subsidiaries without a PUHCA and can do the same with electrics.

Approach Two would not affect Georgia at all because we do not have a one subsidiary holding company.

Please let us know if we may be of further assistance.

Yours very truly,

Ford B. Spinks

Ford B. Spinks
Chairman

FBS:rs

STATE of INDIANA
PUBLIC SERVICE COMMISSION
901 STATE OFFICE BUILDING
INDIANAPOLIS 46204

December 2, 1981

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The Honorable Tom Corcoran, M.C.
House of Representatives
1107 Longworth House Office Building
Washington, D.C. 20515

Dear Representative Corcoran:

My apologies in being so long in replying to your letter of October 27, 1981. At a meeting of the National Association of Regulatory Utility Commissioners (NARUC) in San Francisco last month your letter, which was apparently sent to the Chairman of many, if not all, state utility commissions, was discussed. As you may know, the NARUC has formed an Ad Hoc Committee to study the issue of diversification. While the questions posed by the attachment to your letter do not deal solely with diversification, nevertheless the work product of the study committee will be relevant to most of the issues raised in your letter and attachment. It therefore seemed to be the consensus at the NARUC Executive Committee meeting that the NARUC should attempt to answer your letter after further deliberation by its Executive Committee following a report of its Ad Hoc Committee on Diversification.

In the meantime, although some state commissions may prefer to defer to the NARUC generic review, state commissions may still wish to respond to those questions you raised dealing with state specific situations. Insofar as this state commission is concerned, I would prefer waiting to answer your letter until the NARUC Ad Hoc Committee on Diversification has completed its work, especially since I am the member of that Ad Hoc Committee charged with the specific responsibility of concentrating on the effect of diversification on the electric utility industry. I would, however, like to make one observation now that I doubt would be changed by the outcome of the NARUC study: I do not believe the implied assumption in question 4 of the attachment to your letter that the public has more confidence in federal regulation than it does in state regulation is justified.

Yours truly,

Larry Wallace

Larry J. Wallace
Chairman

gk
cc: The Honorable Stanley York, Chairman, Wisconsin Public Service Commission and Chairman of NARUC Ad Hoc Committee on Public Utility Diversification
Paul Rodgers, NARUC

Public Utility Commission of Texas

George M. Cowden
Chairman

H. M. Rollins
Commissioner

Garrett Morris
Commissioner

November 30, 1981

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DAN'S NOTES:

The Honorable Tom Corcoran
The United States House of Representatives
Washington, D.C. 20515

Dear Mr. Corcoran:

Chairman Cowden has asked me to respond to your letter of October 27, 1981 concerning the possibility of repealing or amending the Public Utility Holding Company Act of 1935 (PUHCA). Before discussing the possible advantages and disadvantages that might result from repeal of the PUHCA, I will begin with a brief description of the current situation in the State of Texas in so far as it relates to this legislation.

The Public Utility Regulatory Act of June 1975 which created this Commission gives it broad authority for ratemaking purposes over utility company transactions with affiliated interests. The Act gives the Commission the authority to determine the reasonableness of all payments to affiliated interests and states that the price to the utility should be no higher than prices charged to other affiliates or unaffiliated parties. Interest and capital costs are specifically mentioned in this section.

Therefore, under our Act, the Commission currently has the authority to prevent abuses by members of holding companies in this one area. However, the Commission does not have the authority to regulate the issuance of securities or the payment of dividends by utility companies under its jurisdiction. Therefore, repeal of the PUHCA would leave these two activities unregulated for utility companies in Texas.

Texas is currently the only state in the continental United States that is not interconnected with other states. Several electric utilities in Texas are members of the Economic Reliability Council of Texas (ERCOT) and have been unwilling to interconnect with other regional power pools. Repeal of PUHCA itself may not be sufficient to overcome this unwillingness. Other aspects of federal regulation would have to be addressed in order to foster greater cooperation between ERCOT and other regional power pools.

At present most electric utilities in Texas are engaged in large-scale construction programs designed to convert from oil and gas powered units to coal and nuclear energy. Also, Texas electric utilities face a higher than average growth in peak demand over the next two decades. These facts mean that Texas electric utilities will continue to have extremely large capital requirements through the remainder of this century.

In light of this background, I will briefly review the possible benefits and negative consequences of repealing or amending the PUHCA. The Commission Staff is now in the process of studying various proposals for the deregulation of the electric utility industry. Preliminary research has shown that a restructuring of the industry that would facilitate economies of scale, especially the coordination of the planning, construction and dispatch of plants over broad areas, might be highly beneficial to the national economy. However, we have not determined whether repeal of the PUHCA or some other legislative action would be the best way to achieve this goal.

Diversification of the industry could be a two-edged sword. It might serve to strengthen the industry financially, or it might prove to be injurious to utility customers if companies siphon resources away from utility services to other, more profitable businesses. I should note here that Texas utilities have continued to enjoy good access to the capital markets primarily because they have been able to maintain their financial health.

Several negative consequences of repealing or amending PUHCA also should be noted. One that is of particular concern to us here in Texas is the question of whether an unregulated parent company will continue to make the large-scale investment required to maintain and expand utility service in our rapidly growing state. We have experienced this problem first hand in the telephone area. In its last two rate cases before this Commission, the rate of return on equity to General Telephone Company of the Southwest (GTSW) was lowered because of the poor quality of service provided to Texas customers. A major factor contributing to the poor quality of service and inadequate equipment in Texas was thought to be insufficient investment over the years by the parent company, General Telephone and Electronics Corporation, in its Texas subsidiary. The possibility that this phenomenon could reoccur with frequency if the holding company structure proliferated is a source of concern to us.

Another aspect of this problem is that repeal of the PUHCA would undoubtedly make our job as the local regulatory authority more complex. If utilities were part of large, complicated corporate structures, they would be more difficult to regulate. In particular, there is the potential problem of the cross subsidization of competitive services by noncompetitive services. This has proved to be one of the most difficult issues in the deregulation of the telecommunications industry.

We at the local level are also concerned about the possible use of scarce capital resources for mergers and acquisitions unrelated to utility service. Also, will parent company management be as responsive to local needs for utility services as companies headquartered in Texas or in neighboring states?

In conclusion, there appear to be both potential benefits and problems associated with the deregulation and restructuring of the electric utility industry. Repealing or amending the PUHCA may have beneficial effects on the financial health of the industry by expanding its capital market appeal. However, repeal of the PUHCA could have serious negative consequences, particularly in the area of maintaining high quality utility service in an increasingly complex corporate environment. We as state regulators would like to see more research on the possible consequences of such legislation before we can accurately assess its potential benefits to our ratepayers in Texas.

Sincerely,

John E. Cunningham

John E. Cunningham
Director of Public Utilities

JEC/pm

STATE OF DELAWARE
THE PUBLIC SERVICE COMMISSION
1560 SOUTH DUPONT HIGHWAY
DOVER, DELAWARE 19901

November 24, 1981

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DAN'S NOTES:

The Honorable Tom Corcoran
Congress of the United States
House of Representatives
Washington, D.C. 20515

Re: Public Utility Holding Co. Act of 1935 (PUHCA)

Dear Representative Corcoran:

You have requested my comments as a State regulator concerning possible modifications to the 1935 Act (PUHCA).

I share your concern about statutory and regulatory barriers which may inhibit the ability of utilities to financially help themselves and their stockholders and ratepayers. However, I am equally concerned that well intentioned revisions do not significantly and adversely impact the abilities of State regulators to effectively act in the public interest.

In Volume 2 of his "Principles of Public Utility Regulation" on page 507, the noted author, A. J. G. Priest, introduces his chapter on the PUHCA with the following comments:

> "The Public Utility Holding Company Act of 1935 (15 U.S.C. §§79-79Z (1964) was a major legislative achievement of the New Deal. It was: (1) highly controversial, (2) strongly resisted (e.g. §11, the so-called 'death sentence' which provided for the simplification of holding company systems, passed the Senate by a single vote), (3) so admirably drafted that all attacks on its constitutionality vaporized and that only three of its sections (§18, 24, and 25) have been subjected to amendments (all of them minor), and (4) patently (hindsight never fails) in the public interest."

This legislation was obviously a carefully considered response to serious regulatory problems.

It may well be that the current economic realities provide the basis for consideration of revisions to the Act; however, I would sincerely hope that proposed solutions to the financial and growth problems of utilities fully consider and not reintroduce in a new form the management, accounting, and financing abuses which were designed to be corrected by the original legislation.

In short, modification of PUHCA may provide increased financing flexibility, will most probably foster and promote diversification, and should not do either without the proper controls to insure the continued provision of high quality public utility service at reasonable rates.

Very truly yours,

Joshua W. Martin III

Joshua W. Martin, III
Chairman

JWM/njs

State of Kansas

JOHN CARLIN — Governor
RICHARD C. (PETE) LOUX — Chairman
E T. ROY — Commissioner
LLIP R. DICK — Commissioner
CAROL J. LARSON — Executive Secretary
BRIAN J. MOLINE — General Counsel

State Corporation Commission

Fourth Floor, State Office Bldg.
Ph. 913 296-3355
TOPEKA, KANSAS 66612

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DAN'S NOTES

November 25, 1981

The Honorable Tom Corcoran
House of Representatives
1107 Longworth House Office Building
Washington, D.C. 20515

RE: Proposed repeal of the Public Utility Holding Company Act (PUHCA).

Dear Congressman Corcoran:

In your letter of October 27, 1981, you state that you are interested in possible changes to the Public Utility Holding Company Act (PUHCA) as one approach to removing regulatory barriers that may inhibit the ability of utilities to "financially help themselves and their stockholders and ratepayers." Implicit in any approach to repeal or limit the scope of PUHCA is the assumption that diversification or expansion in the utility industry is either necessary or beneficial to the financial health of the utility industry. The validity of this assumption is untested; this assumption ignores the reality that most utilities could best improve their financial situation through more efficient use of resources presently available. The examples of steps to be taken in this direction include: enchanced load management and increased interconnects. The objectives of conservation and more efficient use of current generating equipment should take priority over diversification if the utility industry is to achieve long-term financial stability.

The multi-state Holding Company poses threats to effective State regulation in two ways. First, the holding company device may be used to escape jurisdiction of states which have no statutory authority over holding companies. Kansas has resolved this problem by passage of its own Utility Holding Company Act, K.S.A. 66-1401 et seq., giving this Commission jurisdiction over affiliated interests and holding companies for purposes of ratemaking and contract review. The second and more real threat is the practical problem of addressing large holding companies effectively given the limitations of state regulatory commissions. Most state commissions have relatively small staffs and limitations upon the time in which they are allowed to hear cases and render decisions. Within these constraints it is very difficult, if not impossible, for a state commission to regulate in any meaningful way a large utility with many diverse affiliates.

The Public Utility Holding Company Act serves as a safeguard for the interest of State regulation of utilities. PUHCA tends to limit the size of holding companies and tends to limit holding companies to specific contiguous geographic areas. These limitations keep utilities within the practical and jurisdictional reach of State agencies. With these general statements in mind, I turn now to the specific questions posed by your letter.

Approach No. 1.

Outright repeal of PUHCA does not appear to serve the best interest of State Utility Regulation. Repeal of PUHCA would open the door for the creation of utilities large enough to be beyond the ability of review of the state commissions. In some cases states may not have jurisdiction over large holding companies; efforts by states to limit or prohibit the creation of large holding companies would result in a patchwork of regulation and tend to discourage diversification by utilities. Although the size of electric and gas utilities does not currently pose a problem for state regulation, this Commission's experience suggests that state commissions do not have the resources to regulate a company such as AT&T and its affiliated interests.

One can safely assume that most of the public hold no strong opinions on whether holding companies should be regulated at the State or Federal level. The public is aware of the shifting responsibility from the Federal to State governments generally, and the public is acutely aware of higher utility bills. At the same time, there is no evidence that the public is willing to pay the cost of increased State regulatory responsibility that would result from requiring states to regulate utility holding companies. For these reasons, an outright repeal of the PUHCA would be undesirable from a State regulator's perspective.

Approach No. 2.

The second approach appears to reach a similar result. The provision exempting holding companies created by companies presently exempt under Section 3(a)(2) of the Act would allow virtually any utility not presently subject to PUHCA to create a holding company, and thereby escape provisions of PUHCA. Removal of the "unless and except" clause; of course, would require exemption of such holding companies whether in the public interest or not. Such provisions would have the effect of de facto repeal of PUHCA concerning companies not currently subjected to its provisions.

The same objections offered above to the first approach apply here. Under Approach No. 2 states would be compelled to enact their own statutes governing holding companies in order to continue effective regulation of utilities in their respective jurisdictions. Once again, irregularities would arise in the regulation of holding companies, uncertainty of the government regulatory environment would increase, and diversification would be discouraged.

The attempts to limit the effects of the Public Utility Holding Company Act are undesirable from the State Regulator's perspective. Furthermore, it appears the approach as suggested in your letter would not achieve the objectives of encouraging diversification in the utility industry. To reiterate, the problems of the utility industry will not necessarily be addressed by enhancing the environment for diversification and expansion. William E. Wall, Chairman, of Kansas Power and Light Company, recently stated: "There is nothing wrong with any electric utility that a fair rate of return would not cure." Repeal of the Public Utilities Holding Company Act at this time would be unfortunate.

Sincerely,

Pete Loux

R. C. (Pete) Loux, Chairman
Kansas Corporation Commission

COMMONWEALTH OF VIRGINIA

THOMAS P. HARWOOD, JR.
CHAIRMAN
JUNIE L. BRADSHAW
COMMISSIONER
PRESTON C. SHANNON
COMMISSIONER

WILLIAM C. YOUNG
CLERK OF THE COMMISSION
BOX 1197
RICHMOND, VIRGINIA 23209

STATE CORPORATION COMMISSION

November 23, 1981

[illegible] NOTES. Q/

The Honorable Tom Corcoran
1107 Longworth House Office Building
Washington, D. C. 20515

The Honorable Tom Corcoran:

I have read with interest your letter and discussion paper concerning the Public Utility Holding Company Act of 1935. Your efforts to understand the perspective of public utility commissions concerning a possible repeal or amendment to PUHCA is appreciated.

It would appear that PUHCA is an outdated piece of legislation that should either be repealed or restructured. The problems that existed in the corporate structures of certain utility holding companies 46 years ago are no longer present. Many of the utility holding companies of that time apparantly were based on a pyramid type structure that would possibly collapse in times of economic difficulty. The same is not true today.

Today's utility industry is faced with a multitude of problems. The PUHCA represents a layer of regulation upon the companies it controls that is often redundant. For instance, most companies regulated by the Act must get prior approval for financing from both the SEC and a state regulatory agency. Delays in approval of financing methods can be critical in today's unsettled financial markets. We must allow utilities to function with flexibility in this area. This flexibility will, in the long run, benefit both the stockholder and ratepayer.

If the PUHCA were repealed, the interests of the stockholder and ratepayer in Virginia would continue to be protected by our Commission. We already monitor changes in the structures of the utilities we regulate. For instance, a common procedure in our rate case audits is to study the changes in the structure of charges a parent company passes on to its subsidiary.

It is impossible to predict how repeal of the PUHCA would affect the diversification efforts of the companies involved. It must be remembered, howerer, that only a small percentage of the companies we regulate are controlled by the PUHCA. Diversification is an issue we must face whether the Act is repealed or not.

I feel the public in the Commonwealth of Virginia does have enough confidence in our Commission so that the federal role in regulation can be reduced. I have no doubt that we will be able to provide adequate regulatory oversight in the event of repeal or amendment to the Public Utility Holding Company Act of 1935.

Sincerely,

Preston C. Shannon
Commissioner

PCS/lmt

COMMISSIONERS
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WILLIAM A. BADGER
LILO K. SCHIFTER
WAYNE B. HAMILTON
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STATE OF MARYLAND

JAMES A. PINE
GENERAL COUNSEL
RONALD E. HAWKINS
EXECUTIVE SECRETARY
GLORIA M. JIMENEZ
EXECUTIVE DIRECTOR

PUBLIC SERVICE COMMISSION
AMERICAN BUILDING
231 E. BALTIMORE STREET
BALTIMORE, MARYLAND 21202
(301) 659-6000

TTY FOR DEAF: BALTO. AREA 383-7555
D.C. METRO 565-0461

November 24, 1981

The Honorable Thomas Corcoran
Representative in Congress
House of Representatives
Washington, D.C. 20515

Dear Mr. Corcoran:

This is in response to your letter of October 21, 1981 to Chairman Hatem with regard to the amendment or repeal of the Public Utility Holding Company Act of 1935. This is an issue which we have not completely researched so at this point I can only provide you with the staff's first impressions of the possibility of repeal or amendment.

While the utilities regulated by this Commission might disagree, it would appear that PUHCA has not inhibited the diversification moves of a number of them. As long as the rate payers are not prejudiced by these activities and funds are not siphoned from the regulated business to the unregulated activities, regulatory bodies should not be concerned. Our experience with the telephone industry, however, indicates that there are great difficulties in keeping these activities separate. The staff of this Commission would recommend that we approach any change in the status quo with caution.

I regret that we cannot be of more assistance at this time. When we have done some further research in this area, we will most certainly share our thoughts with you.

Sincerely,

Glo Jimenez

Gloria M. Jimenez
Executive Director

REC #

GMJ:adr

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ICTOR ATIYEH
GOVERNOR

PUBLIC UTILITY COMMISSIONER OF OREGON

LABOR & INDUSTRIES BUILDING, SALEM OREGON 97310 PHONE (503) 378-6611

November 19, 1981

The Honorable Tom Corcoran
US House of Representatives
Washington DC 20515

Oregon is a smaller state in terms of the number and size of the utilities its regulates. As such, we have had only minor problems to date concerning the Public Utility Holding Company Act of 1935, nor have any of the utilities in the state expressed to us significant concerns in this area.

I can say that with regards to Question 4 of your "Approach One" that there appears to be public confidence in the regulatory process in our state. Although there is little federal regulation of local utilities in Oregon, we have found that such regulation is sometimes slow in responding and inferior to state regulation if only because of its remoteness from the jurisdiction involved. We would, therefore, expect to see that all interests--consumers and investors--are protected in our regulatory process regardless of any changes in the Act.

I would certainly favor repeal.

John L. Lobdell
Commissioner

wr/1727W

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State of Wisconsin PUBLIC SERVICE COMMISSION

STANLEY YORK, CHAIRMAN
WILLIE J. NUNNERY, COMMISSIONER
BRANKO TERZIC, COMMISSIONER
4802 SHEBOYGAN AVENUE
P.O. BOX 7854
MADISON, WISCONSIN 53707
(608) 266-1241

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November 13, 1981

File No.

The Honorable Tom Corcoran
U.S. House of Representatives
1107 Longworth House Office Building
Washington, D.C. 20515

Dear Representative Corcoran:

Thank you for your letter of October 27, 1981, concerning possible changes in the Public Utility Holding Company Act of 1935. At the present time, one Wisconsin gas utility is subject to PUCHA, and two Wisconsin combination gas and electric utilities have applied to the Securities and Exchange Commission to form holding companies. This commission is therefore concerned about holding company issues both within Wisconsin and nationally.

Our chief economist, J. Robert Malko, and his staff have prepared a report on the issues involved with the regulation of energy utility diversification and utility holding companies. I have enclosed a copy of this report, which has been circulated nationally among regulators, utilities and public counsels. Your discussion outline/questions on PUCHA have been referred to Dr. Malko's office. For this commission's concerns specific to Wisconsin, please read the enclosed letter to the SEC dated October 9, 1981.

I have been appointed Chairman of the recently established Ad Hoc Committee on Utility Diversification of the National Association of Regulatory Utility Commissioners. A copy of drafts for the report study plan outline are enclosed. The committee will meet in San Francisco on November 19. The committee's report will discuss the matter of federal regulation of utility holding companies. We will, therefore, keep you informed on this aspect of our work.

Sincerely,

Stanley York

Stanley York
Chairman

SY/GE/dm

Enclosures

IDAHO PUBLIC UTILITIES COMMISSION

STATEHOUSE
BOISE, IDAHO 83720
334-3143

PERRY SWISHER
President

JOHN V. EVANS
Governor

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DAN'S NOTES:

November 11, 1981

The Honorable Tom Corcoran
U. S. Representative
1107 Longworth House Office Bldg.
Washington, D. C. 20515

Dear Mr. Corcoran:

Your name evokes memories of Tommy the Cork. A very different breed of Irishman.

Enclosed is an excerpt from an analysis by Leonard Hyman of Merrill Lynch. He's the best establishment analyst of electric utilities, in my experience.

Distributing elecrticity is a natural, cost-effective monopoly. Producing energy, including electricity, is not. So I urge conservatives like you to help marketplace principles work in supplying energy. Encourage utility executives to wean themselves from a fixation on central plant in this era when once again energy is where you find it.

We need mix, diversity, competition, the innovativeness of the private sector. Let entrepreneurs harness resources that are now wasted, undeveloped, or denied the subsidies that flow to the old suppliers.

I agree with you that the Holding Company Act is obsolete in several important respects. You should be working for changes. But you live in the land of Samuel Insull (as well as Lincoln) while I live where many of us did without in the Insull-Ebasco era--despite our magnificant hydro resource. The key is not in restoring the iron-tight trusts of the 1920's but in going back still farther: To pre-World War I when industry, not utilities, originated more than half of the electricity generated and every community contained a mix of energy from resources close at hand.

As long as Republicans are in the saddle, ride all the way back to Theodore Roosevelt. The Calvin Coolidge approach won't work. It never did. When national leadership turns bland, things climb in the saddle "and ride mankind."

Very truly yours,

Perry Swisher
President

PS:kl

Who gains from the perpetuation of the natural monopoly concept beyond its useful life? Clearly the big user of power. Who loses? The utility company. What about the economy as a whole? Just a clearly, the present system leads to misallocation of resources and excessive use of electric energy.

X LEONARD HYMAN OF MERRILL LYNCH

3) The principle that electricity is a religion rather than a commodity - Many regulators and industry executives take the view that central station electricity is different from other services and commodities. They point out that the economy will stop without it, that electricity will play a big role in reducing our dependence on oil, that automation won't take place without it, and on and on. Now let's take this argument to its logical conclusions, conclusions that were drawn by public power advocates in the 1920s and 1930s, incidentally. Not only must price be controlled so that all can afford their fair share, but quality of service must remain at extraordinarily high levels because nobody can afford to be without power. Furthermore, we must not tinker with the present system if doing so will have any impact on availability or price of power. Now for the clincher: maybe electricity is too important to be left in the hands of private enterprise. As far as I am concerned, this view of electricity as a religion is one of the greatest threats to the viability of the industry. I don't see why society should make the value judgment that electricity should be furnished to the consumer at a price below economic costs, with the subsidy coming from investors, as opposed to the furnishing of other services or commodities by private companies. Generally, it is left to government-owned entities to provide services below cost for social reasons. My point is that many users of electricity would accept a different standard of service if price were adjusted to make such acceptance worthwhile. Moreover, if the price of central station power were realistic, many users might find it advantageous to provide their own power. In other words, with proper pricing, users would see central station power more as a commodity that could be replaced by other commodities. Suppliers would make decisions on an economic basis, rather than acting as missionaries offering salvation to the pagans. The invisible hand would be unchained, and we could see ar [illegible] to the mismatch between supply and demand.

These principles apply to both diversification and deregulation. Let's first attack diversification, which most of you will acknowledge as a possibility. What are the motives to diversify?

Motive # 1: Promote a higher stock price by convincing investors that the utility will metamorphose into an exciting company sometime in the future. That way you get a better stock price and can throw money with abandon into your utility operation. Sad to say, investors aren't fooled that easily. They won't pay for intentions.

Motive #2: Build an empire. No comment required.

Motive # 3: Reduce the risk inherent in a one-line business. Try not to pick a second line riskier than the first, though.

Motive #4: Protect market share, after market is defined as the end use. Seek to serve that end use for energy in the most profitable and economical fashion, rather than only through central station power.

Motive #5: Make profitable use of assets and expertise already within the corporation in an unregulated environment.

STATE OF COLORADO

THE PUBLIC UTILITIES COMMISSION
Department of Regulatory Agencies
500 State Services Building
1525 Sherman Street
Denver, Colorado 80203

Richard D. Lamm,
Governor

Wellington E. Webb,
Executive Director

COMMISSIONERS:
Edythe S. Miller,
Chairwoman

Daniel E. Muse
L. Duane Woodard

Harry A. Galligan, Jr.,
Executive Secretary

Administration (303) 866-3
Transportation (303) 866-3
Fixed Utilities (303) 866-31
Counsel (303) 866-3188

November 10, 1981

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DAN'S NOTES

The Honorable Tom Corcoran
United States Representative
1107 Longworth House Office Building
Washington, D.C. 20515

Dear Representative Corcoran:

I am in receipt of your letter of October 27, 1981, concerning possible amendments or repeal of the Public Utility Holding Company Act of 1935. Due to time constraints, we will not be able to respond to your letter by November 25, 1981. However, it may be possible for us to provide you with our views at a later date, assuming sufficient time is allowed, with respect to the two approaches outlined in the discussion paper attached to your letter. If this will be helpful, please let us know, and also the outside date by which a response would meet your needs.

Very truly yours,

Edythe S. Miller

EDYTHE S. MILLER
Chairwoman

ESM/vjr

GEORGE R. ARIYOSHI
GOVERNOR

STATE OF HAWAII
PUBLIC UTILITIES COMMISSION
DEPARTMENT OF BUDGET AND FINANCE
1164 Bishop Street, Suite 911
Honolulu, Hawaii 96813

JENSEN HEE
DIRECTOR OF BUDGET & FINANCE

ALBERT Q.Y. TOM
Chairman

Clyde S. DuPont
Commissioner

SUNAO KIDO
Commissioner

November 13, 1981

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The Honorable Tom Corcoran
Representative, 15th District
Congress of the United States
House of Representatives
Washington, D.C. 20515

Dear Representative Corcoran:

The Commission received your letter of October 27, 1981 with enclosure of proposals concerning amendments to the Public Utility Holding Company Act of 1935.

The regulatory commissions throughout the country are being confronted with diversification requests by the regulated utility companies under their jurisdictions. While the plight of the utility industry to seek alternatives is recognized by most regulatory commissions, the major concern of the commissions have been the exposure of utility assets and operations to insure adequate and reliable utility service to the public.

While each state regulatory commission will continue to exercise its regulatory responsibilities as to the regulated utility within its jurisdiction, a uniform compact agreement between the states may be necessary to assure state by state cooperation in non-regulated activities that may impact on the regulated portion. Similarly, a compact agreement between all states will facilitate the affected holding company's reporting requirements with respect to the regulated operations of the company in the states in which they operate.

In essence, we favor the features in your proposed Option Plan II with possible modifications while retaining the general concept of the Public Utility Holding Company Act which will also provide the Securities and Exchange Commission an opportunity to review any weak ares that the respective state statutes' may have at the present time or in the foreseeable future. As a member of NARUC, we also support the position of the organization on the subject matter.

We hope the foregoing comments will assist you in the review of the Public Utility Holding Company Act of 1935 and your concurrent concerns on the financial plight of the utility industry. We share the same concerns on the well-being of the utilities, while equally being concerned of the interest of the utility ratepayer.

Very Truly Yours,

Albert Tom

Albert Tom, Chairman

cc: The Honorable Daniel K. Inouye
Senator, State of Hawaii

The Honorable Spark Matsunaga
Senator, State of Hawaii

The Honorable Cecil Heftel
Representative, State of Hawaii

The Honorable Daniel Akaka
Representative, State of Hawaii

THE STATE OF WYOMING

ED HERSCHLER
GOVERNOR

Public Service Commission

CAPITOL HILL BUILDING
320 W. 25TH STREET
CHEYENNE, WYOMING 82002

JOHN R. SMYTH
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WILLIAM M. ROONEY
DIRECTOR, MOTOR TRANSPORTATION
WILLIAM L. JOHNSON
DIRECTOR, RATE AND TARIFF

November 9, 1981

Tom Corcoran
Representative in Congress
House of Representatives
Washington, D.C. 20515

Re: Proposed legislative action on Public
Utility Holding Company Act of 1935

Dear Mr. Corcoran:

We sincerely appreciate your permitting us to reply to two legislative approaches to amending the Public Utility Holding Act of 1935 in an effort to relieve the financial plight of the utility industry. This Commission has not been faced with the holding company problem since only one very small gas utility (Cody Gas Company) would be affected; therefore, we do not feel it appropriate to venture unsupported opinions.

We appreciate your keeping us advised on this important matter.

Yours very truly,

John R. Smyth

JOHN R. SMYTH, Chairman

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Representative CORCORAN. This bill would amend section 3 of the Holding Company Act to facilitate the formation of and diversification by exempt electric and gas utility holding companies. It also provided that diversified activities of a utility holding company should be undertaken through the use of a separate corporate subsidiary which would prevent cross subsidization between the utility and the nonutility businesses. As you know, that is one of the concerns that's raised with any modification of the 1935 Act itself.

Mr. Chairman, as I indicated, Dick Ottinger, who is chairman of the Energy Conservation and Power Subcommittee of the House Energy and Commerce Committee, of which both Congressmen Tauzin and myself are privileged to serve as members, has advised me last week that his committee will be holding hearings on the act either in late May or early June.

Mr. Chairman, even though I think our friend and your colleague from New York, Mr. Ottinger, has some misgivings bout any total repeal of the act——

Senator D'AMATO. Only some?

DIVERSIFICATION INTO NONUTILITY BUSINESSES

Representative CORCORAN. It's early in the morning and I tend to be cautious at this hour. He did indicate on one occasion, however, that he thought the Holding Company Act may be, "a barrier to innovative utility management." So I think even there there is some indication of an awareness that perhaps diversification into nonutility businesses might be something that we could usefully explore.

One of the important questions relating to utility diversification concerns the types of businesses into which utilities are likely to diversify and I'd just like to address that for a moment if I might.

Several business activities have been generally identified in various surveys as presenting opportunities that may merit consideration by certain utilities. Among these are various alternative energy sources such as solar power, wind generation and refuse-derived fuel, coal and other mineral and resource development, petroleum exploration, development and production, computer services—for instance, with load management and other types of use for the automatic data processing—and of course, other conservation techniques.

And in addition, I think there's some interest in industrial real estate development, primarily of properties presently held by utilities but no longer useful in the utility business itself.

Diversification into these areas could be undertaken by utilities in joint ventures with industrials through the creation of a new business of the acquisition of an existing one or simply as a passive investor.

In any event, the likely areas of diversification are those that are energy related and would further the development of our Nation's energy resources in addition to improving the financial performance of the utility industry.

In that respect, let me just conclude with one point, Mr. Chairman, and that is, one of the other factors that led to my consideration of some change or perhaps repeal of the Act.

I think we as policymakers ought to remove any unnecessary statutory roadblocks to the prospect that utilities might join in joint ventures with other businesses such as Caterpillar in building new powerplants to replace obsolete ones or meet new demand requirements. I say Caterpillar because it is a profitable company which could take advantage of existing tax incentives, and because its interest in the coal industry might cause it to become involved in such a project. However, today Caterpillar would not even consider such a venture in my judgment because it would automatically be treated as a utility under the Act.

And so I think that sort of proves part of the concern that caused me to examine this matter and that is, that while we have investment tax credits and lots of other incentives for the conversion of old powerplants into new ones which, for instance, in the Northeast would get us off of the excessive dependence on oil for electricity generation—the fact is, from the profitbility standpoint public utilities are not really in a position to take advantage of these opportunities.

However, Caterpillar would be in such a position. They might be interested if they were approached properly to build—at least finance the construction of a generating facility and then lease it back in some way to the utility for all of the other aspects of providing electricity to various consumers in the State of Illinois. However, the problem that Caterpillar or any other industrial company would face at that point would be that under the Act today they would be drawn under in terms of being required to be treated as a public utility. Well, I think the last thing in the world Caterpillar Tractor Co. wants is to be treated as a public utility.

And so one of the reasons that we approached this question was to see whether or not we couldn't coordinate other nonutility businesses into the energy production, into this field, and to do so, of course, I think we would have to clarify, as our legislation would do, whether or not such companies need be treated for purposes of the Public Utility Holding Company Act as public utilities.

So I think this is the thrust of what we're trying to do and I want to reiterate my congratulations to you and your colleagues for your serious consideration of this legislation and I assure you that we in the House, not just my colleague from Louisiana and myself, but I think others, will be looking forward to working with you on this matter. Thank you.

Senator D'AMATO. Congressman, let me commend you for an excellent presentation of some of the problems that exist in the industry. I know personally that many of the issues you raised face some of the power companies in New York, in my home community of Long Island in particular. My experience suggests that we need to open up the utility industry to investors that otherwise would be very reluctant to become involved—and indeed, certain of my distinguished colleagues—the junior Senator from New Jersey—probably share this view. With his background, he would be in a position to indicate that very few companies today would be counselled to invest in a utility and become subject to the Holding Company Act, and its various requirements and regulations.

But let me commend you for your interest, your participation, your work on the House side and your appearance here today. We're deeply appreciative.

Representative **Corcoran**. Thank you very much.

STATEMENT OF SENATOR SCHMITT

Senator **Schmitt**. Mr. Chairman, I would like to commend Senators D'Amato and Johnston for their efforts in bringing the matter of The Public Utility Holding Company Act to the attention of this committee. Old laws should be updated from time to time. The four bills that we are addressing today provide a good starting point for discussing an update of this 1935 law.

I have not yet taken a position on any of the bills dealing with public utility holding companies. In general, I support the deregulation of industry. In a market where there are many buyers and sellers and a great amount of information available on the quality of goods and services available, there is no need for regulation. The marketplace will regulate itself. However, in the case of natural monopolies, where competition is not economically justified, some regulation is needed. Certainly rate payers deserve to be protected; perhaps, people who buy and sell stock of public utility holding companies deserve this protection too.

As we all know, 80 percent of the electricity privately generated in the early 1930's came from vast utility holding companies. This market concentration led to abuses which effected rate payers and investors. These abuses included: Complicated financial positions; injudicious diversification; and "creative accounting" producing nonexistent profits and misallocating vital investment resources.

In addressing change we must make sure that we do not signal a return to the 1930's. Many utilities are diversifying in an attempt to hedge the costs of acquiring raw materials. This attempt at diversification has moved some utilities close to the point where they may fall under the provisions of this act. We must insure that investors in public utilities are properly informed about the risk of diversification, and that the investors are not subsidizing an unwise investment on the part of a utility holding company.

I might say, Mr. Chairman, that there are no companies in New Mexico which fall under this act. It is my hope that the utilities in my State never do. I would like to commend you once again Mr. Chairman for moving forward with this. I am sure the committee will act in a responsible and responsive fashion.

[Copies of the bills being considered and letter and statement from the Department of Energy follow:]

II

97TH CONGRESS
1ST SESSION

S. 1869

To amend the Public Utility Holding Company Act of 1935 to simplify its administration and to remove restrictions no longer necessary to the protection of investors and consumers.

IN THE SENATE OF THE UNITED STATES

NOVEMBER 19 (legislative day, NOVEMBER 2), 1981

Mr. D'AMATO (for himself and Mr. JOHNSTON) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To amend the Public Utility Holding Company Act of 1935 to simplify its administration and to remove restrictions no longer necessary to the protection of investors and consumers.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

SECTION 1. This Act may be cited as the "Public Utility Holding Company Act Amendments of 1981".

FINDINGS AND STATEMENT OF PURPOSES

SEC. 2. (a) The Congress hereby finds that—

(1) business, market, and regulatory developments over the forty-six year history of the administration of the Public Utility Holding Company Act of 1935 have rendered certain of the provisions of the Act—

(A) unnecessarily restrictive of business activity; or

(B) duplicative of a broad range of regulatory controls administered by State and Federal authorities under a number of other laws; and

(2) an adequate basis exists for lessening the regulatory control of, and burden on, registered holding companies and subsidiary companies and subsidiary companies thereof, consistent with the protection of investors and consumers.

(b) The purposes of this Act are—

(1) to remove restrictions on business activity no longer necessary or appropriate in the public interest; and

(2) to simplify and allow for greater flexibility in the administration of the remaining requirements of the Public Utility Holding Company Act of 1935.

DEFINITIONS

SEC. 3. Section 2(a) of the Public Utility Holding Company Act of 1935 is amended—

(1) by amending paragraph (18) thereof to read as follows:

"(18) 'Utility assets' means the facilities, in place, of any electric utility company directly employed in, and the primary function of which is, the production, transmission or distribution of electric energy, or the facilities, in place, of any gas utility company directly employed in, and the primary function of which is, the transportation or distribution of natural or manufactured gas or the production of manufactured gas."; and

(2) by adding at the end thereof the following new paragraph:

"(30) 'Unsound financial practice' means a financial practice which the Commission determines would result in an unreasonable risk to investors or consumers, giving due consideration to the financial practices of public-utility companies and holding-company systems which are not subject to regulation under section 6 and section 7 of this title.".

REFORM OF SECURITIES ISSUANCE CONTROLS

SEC. 4. Sections 6 and 7 of the Public Utility Holding Company Act of 1935 are amended to read as follows:

"REGULATED SECURITY TRANSACTIONS BY REGISTERED HOLDING AND SUBSIDIARY COMPANIES

"SEC. 6. (a) Except in accordance with a declaration effective under section 7, it shall be unlawful for any registered holding company or subsidiary company thereof, by use of the mails or any means or instrumentality of interstate commerce, or otherwise, directly or indirectly—

"(1) to issue or sell any security of such company; or

"(2) to exercise any privilege or right to alter the priorities, preferences, voting power, or other rights of the holders of an outstanding security of such company, unless the issue, sale, renewal or guaranty of, or assumption of liability on, such security is exempted from this subsection under, or pursuant to the authority of, subsection (b) of this section.

"(b)(1) The provisions of subsection (a) shall not apply to—

"(A) the issue, sale, renewal or guaranty of, or assumption of liability on, a note or draft (including the pledge of any security as collateral therefor) by a registered holding company or subsidiary company thereof if such note or draft—

"(i) is not part of a public offering,

"(ii) matures or is renewed for not more than nine months, exclusive of days of grace, after the date of such issue, sale, renewal, or assumption of liability thereon, and "(iii) aggregates (together with all other then outstanding notes and drafts of a maturity of nine months or less, exclusive of days of grace, as to which such company is primarily or secondarily liable) not more than 10 per centum of the aggregate of the capital, capital surplus and retained earnings and the principal amount of the other securities of such company then outstanding;

"(B) the issue, by a registered holding company or subsidiary company thereof, of a security issued pursuant to the terms of any security outstanding on January 1, 1935, giving the holder of such outstanding security the right to convert such outstanding security into another security of the same issuer or of another person, or giving the right to subscribe to another security of the same issuer or another issuer;

"(C) the issue, sale, renewal or guaranty of, or assumption of liability on, a security by a subsidiary company of a registered holding company if—

"(i) such subsidiary company is a public-utility company,

"(ii) such issue, sale, renewal or guaranty of, or assumption of liability on, a security is issued for the purpose of financing the business of such subsidiary company, or in connection with the financing of the business of another subsidiary company in the same holding-company system, and

"(iii) such issue, sale, renewal, guaranty or assumption of liability is expressly authorized by the State commission of the State in which such public-utility company subsidiary company is organized and doing business;

"(D) the issue, sale, renewal or guaranty of, or assumption of liability on, a security by a subsidiary company of a registered holding company if—

"(i) such subsidiary company is not a public-utility company, a holding company, or an investment company, and

"(ii) such issue, sale, renewal, guaranty assumption of liability is issued for the purpose of financing the business of such subsidiary company, or in connection with the financing of the business of another subsidiary company in the same holding-company system;

"(E) the issue, sale, renewal or guaranty of, or assumption of liability on, any security by a registered holding company or subsidiary company thereof which issue, sale, renewal, guaranty or assumption of liability occurs pursuant to a plan filed and made part of a declaration effective under section 7; or

"(F) the guaranty of, assumption of liability on, a security of a subsidiary company by its registered holding company which is not itself a public utility company, if the aggregate of the principal amount and par value of the securities which are the subject of all such guarantees and assumptions of liability is not more than 10 per centum of the aggregate of capital, capital surplus and retained earnings and the principal amount of the other securities of such registered holding company then outstanding.

"(2) Notwithstanding the exemptions provided in paragraph (1) of this subsection, the Commission may, by rules or regulations, establish such requirements with respect to the consolidated security structure of a registered holding company system as are necessary to prevent an unsound financial practice.

"(3)(A) In addition to the exemptions provided in paragraph (1) of this subsection, the Commission may, by order, upon application by a registered holding company or subsidiary company thereof, exempt from the provisions of subsection (a) the issue, sale, renewal, or guaranty of, or assumption of liability on, any security if the Commission determines the application of subsection (a) to such issue, sale, renewal, guaranty, or assumption of liability is not necessary or appropriate in the public interest or for the protection of investors or consumers.

"(B) The Commission's order under this paragraph granting any such exemption may impose such terms and conditions as the Commission finds are necessary to prevent an unsound financial practice.

"(4) Within ten days, or whatever longer period the Commission prescribes by rule or regulation, after any issue, sale, renewal or guaranty of, or assumption of liability on, any security exempted from the application of subsection (a) by or under authority of this section, such registered holding company or subsidiary company thereof shall file with the Commission a certificate of notification in such form and setting forth such information as the Commission may by rules and regulations or order prescribe as necessary or appropriate in the public interest or for the protection of investors or consumers.

"DECLARATIONS BY REGISTERED HOLDING AND SUBSIDIARY COMPANIES IN RESPECT OF SECURITY TRANSACTIONS

"SEC. 7. (a) A registered holding company or subsidiary company thereof may file a declaration with the Commission, regarding any of the acts enumerated in subsection (a) of section 6, in such form and together with such information as the Commission may prescribe by rules and regulations or order.

"(b)(1) Except as otherwise provided in this subsection, a declaration filed under this section shall become effective on the twentieth day after the filing thereof unless the Commission prior to such effective date shall have issued a preliminary order to the declarant, together with a statement of its reasons—

"(A) disapproving such declaration, or

"(B) approving such declaration subject to terms and conditions.

If the declarant files notice with the Commission of its acceptance of a preliminary order subject to the terms and conditions imposed by the Commission, such preliminary order shall become final without further order or proceeding or opportunity for hearing, and the declaration shall become effective pursuant to such order upon the filing of such notice.

"(2) Within a reasonable time after the issuance of a preliminary order under paragraph (1) and after an opportunity on the part of the declarant for hearing upon such preliminary order, unless the declarant files with the Commission, notice of the withdrawal of its declaration or notice of its acceptance of such preliminary order, the Commission shall enter a final order, together with a statement of its reasons—

"(A) approving such declaration,

"(B) disapproving such declaration, or

"(C) approving such declaration subject to terms and conditions.

"(3) A declaration filed under this section may be in the form of a plan which may provide for the issue, sale, renewal or guaranty of, or assumption of liability on, securities at such times as the declarant may determine to be appropriate over, or within, a period of twelve months or such longer period as the Commission may allow.

"(4)(A) Amendments to a declaration may be made with the consent of the Commission or upon such terms and conditions as the Commission may, by rule or regulation, prescribe as consistent with the purposes of this section.

"(B) If an amendment to a declaration is filed prior to the twentieth day after the filing of such declaration, unless the Commission shall at the time such amendment is filed, consent to the filing thereof, the declaration shall not become effective until the later of the twentieth day after the filing of such declaration or the fifth day after the filing of such amendment.

"(5) The Commission may, by order, without requirement for an opportunity for hearing, upon application, having due regard for the public interest and the interest of investors and consumers, permit a declaration to become effective at a date earlier than the date upon such declaration would otherwise become effective pursuant to paragraph (1) or subparagraph (B) of paragraph (4) of this subsection.

"(c) If a State Commission or State securities commission, having jurisdiction over any of the acts enumerated in subsection (a) of section 6, shall inform the Commission that State laws applicable to an act which is the subject of a declaration filed under this section have not been complied with, the Commission shall not permit such declaration to become effective unless and until the Commission is satisfied that such compliance has been effected.

"(d)(1) Except as provided in subsection (c), the Commission shall permit to become effective a declaration regarding the issue, sale, renewal or guaranty of, or assumption of liability on, a security unless it determines that the acts which are the subject of the declaration involve an unsound financial practice.

"(2) If the Commission issues an order under subsection (b), disapproving a declaration regarding the issue, sale, renewal or guaranty of, or assumption of liability on, a security or approving such a declaration subject to terms and conditions, the Commission's order shall specify the unsound financial practice which it determines to be involved in the acts which are the subject of such declaration.

"(3) The Commission's authority to impose terms and conditions under this section with respect to a declaration regarding the issue, sale, renewal, or guaranty of, or assumption of liability on, a security shall be limited to those terms and conditions which it finds are necessary to prevent the unsound financial practice required to be specified in the Commission's order.

"(e) Except as provided in subsection (c), the Commission shall permit to become effective a declaration regarding the exercise of any privilege or right to alter the priorities, preferences, voting power, or other rights of the holders of an outstanding security, unless the Commission finds that such exercise of such privilege or right will result in an unfair or inequitable distribution of voting power or is otherwise detrimental to the interest of investors or consumers, giving due consideration to the practices of public-utility companies and holding-company systems which are not subject to regulation under section 6 of this title and this section.".

ELIMINATION OF PRIOR COMMISSION APPROVAL OF DIVERSIFIED BUSINESS ACTIVITY

SEC. 5. The Public Utility Holding Company Act of 1935 is amended—

(1) in section 9(a)(1)—

(A) by inserting "of a public-utility company" after "securities"; and

(B) by striking out "or any other interest in any business";

(2) in section 10—

(A) by inserting "For purposes of section 9—" before "(a)";

(B) by striking out ", or of any other interest in any business," in subsection (a);

(C) by striking out "; and" at the end of paragraph (2) of subsection (a) and inserting in lieu thereof a period; and

(D) by striking out paragraph (3) of subsection (a) in its entirety;

(3) in section 10(c)(1), by striking out ", or of any other interest,";

(4) in section 11(a)—

(A) by striking out "necessary or", and

(B) by striking out "the operations of";

(5) in section 11(b)—

(A) by amending paragraph (1) to read as follows:

"(1) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such action as the Commission shall find necessary to limit the operations of the holding-company system of which such company is a part to a single integrated public-utility system, and to such other businesses as are appropriate to such integrated public-utility system: *Provided, however,* That the Commission shall permit a registered holding company to continue to control one or more additional integrated public-utility systems, if, after notice and opportunity for hearing, it finds that—

"(A) each of such additional systems cannot be operated as an independent system without the loss of substantial economies which can be secured by the retention of control by such holding company of such system;

"(B) all of such additional systems are located in one State, or in adjoining States, or in a contiguous foreign country; and

"(C) the continued combination of such systems under the control of such holding company is not so large (considering the state of the art and the area or region affected) as to impair the advantages of localized management, efficient operation, or the effectiveness of regulation.

The Commission shall permit as appropriate to one or more integrated public-utility systems the retention of an interest in any business (other than the business of a public-utility company as such) whether or not functionally related to the business of the integrated public-utility system or systems, unless the Commission shall determine, based upon specific factual findings, that such interest is material to such system or systems and its retention is detrimental to the protection of investors or consumers."; and

(B) by adding at the end thereof the following new paragraph:

"(3) Notwithstanding any other provisions of this title, the Commission shall permit a registered holding company to retain any combination in existence on May 1, 1981, of gas utility systems and electric utility systems unless the Commission finds, after notice and opportunity for hearing, that the combination of systems fails to satisfy the requirements of clauses (B) and (C) of paragraph (1).".

MODIFICATION OF CONTROLS ON INTER-COMPANY TRANSACTIONS

SEC. 6. The Public Utility Holding Company Act of 1935 is amended—

(1) in section 12—

(A) by striking out in subsection (b) "It shall be unlawful for any registered holding company or subsidiary company thereof" and inserting in lieu the following: "Except in the case of a transaction which is expressly authorized by the State commission of the State in which such registered holding company or such registered holding company or such subsidiary company is organized and doing business as a public-utility company, it shall be unlawful for any registered holding company which is a public-utility company or for any public-utility company subsidiary of a registered holding company";

(B) by striking out in subsection (d) "It shall be unlawful" and inserting in lieu the following: "Except in the case of a sale of utility assets used or operated by a public-utility company subsidiary expressly authorized by a State commission with jurisdiction to regulate such subsidiary company, it shall be unlawful"; and

(C) by striking out in subsection (f) "It shall be unlawful for any registered holding-company or subsidiary company thereof" and inserting in lieu the following: "Except in the case of a transaction which is expressly authorized by the State commission of the State in which such registered holding company or such subsidiary company is organized and doing business as a public-utility company, it shall be unlawful for any registered holding company which is a public-utility company or for any public-utility company subsidiary of a registered holding company"; and

(2) in section 13, by adding at the end thereof the following new subsection:

"(h) In the exercise of its authority under this section, the Commission—

"(1) shall not determine the permissible cost to be charged to an associate company by any subsidiary company of a registered holding company by taking into account any earnings fairly and equitably attributable to transaction with, the performance of services for, or sale of goods to, any person which is not an associate company; and

"(2) notwithstanding any other provisions of this title, may, by order, upon application by a registered holding company or any other subsidiary company thereof, if it determines that such action is consistent with the public interest and the interest of investors and consumers, permit a subsidiary company of a registered holding company to perform any—

"(A) sales contract;

"(B) service contract (other than a contract for the performance of traditional management services); or

"(C) construction contract for an associate company at a price (or pursuant to a method of pricing which results in a price) which may be in excess of such subsidiary company's costs, provided such price is equal to or less than the price of comparable contracts performed by persons who are not associate companies or equal to or less than the market cost of such goods.".

CONFORMING CHANGE TO SECURITIES ISSUANCE PROCEDURES

SEC. 7. Section 20(c) of the Public Utility Holding Company Act of 1935 is amended by striking out "Orders" in the last sentence and inserting in lieu thereof "Except as provided in section 7, orders".

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II

97TH CONGRESS
1ST SESSION

S. 1870

To amend the Public Utility Holding Company Act of 1935 to improve financial performance in the electric and gas utility industries by removing unnecessary impediments to the exercise of sound and prudent business judgment by utility executives.

IN THE SENATE OF THE UNITED STATES

NOVEMBER 19 (legislative day, NOVEMBER 2), 1981

Mr. D'AMATO (for himself and Mr. JOHNSTON) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To amend the Public Utility Holding Company Act of 1935 to improve financial performance in the electric and gas utility industries by removing unnecessary impediments to the exercise of sound and prudent business judgment by utility executives.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

SECTION 1. This Act may be cited as the "Diversification Amendments to the Public Utility Holding Company Act of 1935".

FINDINGS AND STATEMENT OF PURPOSE

SEC. 2. The Congress hereby finds that—

(1) the electric and gas utility industries in the United States, once strong and stable, are now experiencing serious and intractable financial difficulties, the consequences of which threaten the existence of these vital national resources, together with the citizens and industry of the United States dependent thereon;

(2) while there may be a number of alternatives available to remedy the financial difficulties confronted by the electric and gas utility industries, it is in the best interests of investors and consumers to encourage the most expeditious of the financial remedies available;

(3) the diversification of a business portfolio, when done prudently, is recognized as both a technically and operationally sound means of improving corporate financial performance by spreading or countering business risk;

(4) prudently managed diversification into nonutility businesses is a normal business practice that

could substantially improve the financial performance of certain electric and gas utilities;

(5) it is in the public interest to remove unnecessary and unintended impediments to the exercise of sound and prudent business judgment by utility executives;

(6) the Public Utility Holding Company Act of 1935 (Public Law 74–333) was intended to correct abuses in the manner in which the utility industry was then conducting its affairs; the legislative intent was not, however, to prevent or in any way interfere with those normal and prudent business practices the benefits of which would accrue to both investors and consumers;

(7) certain provisions of the Public Utility Holding Company Act of 1935 nevertheless act to increase, rather than decrease, business risk in a manner that is detrimental to the interests of investors and consumers by effectively discouraging diversification by electric and gas utilities into nonutility businesses; and

(8) the amendment and the Public Utility Holding Company Act of 1935 to provide for the establishment of a new exemption for holding companies with a subsidiary public utility company meeting certain defined criteria and the establishment of definitive exemptions

would be consistent with the public interest and the interests of investors and consumers and would eliminate those provisions which inhibit normal and prudent business practices and result in increased risk to investors and consumers.

STATEMENT OF PURPOSES

SEC. 3. The purposes of this Act are—

(a) to remove technical restrictions imposed by the Public Utility Holding Company Act of 1935 on those utilities prudently operating in the best interests of their investors and consumers that find it desirable and beneficial to diversify their business activities;

(b) to provide a new exemption under section 3 for a holding company with one subsidiary public utility company that operates in one or more States contiguous to the State in which such subsidiary public utility company is organized;

(c) to provide an exemption for holding companies created by companies that are presently exempt under section 3(a)(2) of the Public Utility Holding Company Act of 1935; and

(d) to provide definitive exemptions in subsection (a) of section 3 so as to reduce the risk of the exercise of prudent business judgment related to diversification by such utilities.

AMENDMENTS TO THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

SEC. 4. The Public Utility Holding Company Act of 1935 is amended to read as follows:

"POWER TO MAKE PARTICULAR EXEMPTIONS REGARDING HOLDING COMPANIES, SUBSIDIARY COMPANIES, AND AFFILIATES

"SEC. 3. (a) The Commission, by rules and regulations upon its own motion, or by order upon application, shall unconditionally exempt any holding company, and every subsidiary company thereof as such, from all provisions of this title, except paragraph (2) of subsection (a) of section 9, if—

"(1) such holding company, and every subsidiary company thereof which is a public-utility company from which such holding company derives, directly or indirectly, any material part of its income, are predominantly intrastate in character and carry on their business substantially in a single State in which such holding company and every such subsidiary company thereof are organized;

"(2) such holding company is predominantly a public-utility company whose operations as such do not extend beyond the State in which it is organized and States contiguous thereto;

"(3) such holding company is only incidentally a holding company, being primarily engaged or interested in one or more businesses other than the business of a public-utility company and (A) not deriving, directly or indirectly, any material part of its income from any one or more subsidiary companies, the principal business of which is that of a public-utility company, or (B) deriving a material part of its income from any one or more such subsidiary companies, if substantially all the outstanding securities of such companies are owned, directly or indirectly, by such holding company;

"(4) such holding company is temporarily a holding company solely by reason of the acquisition of securities for purposes of liquidation or distribution in connection with a bona fide debt previously contracted or in connection with a bona fide arrangement for the underwriting or distribution of securities;

"(5) such holding company is not, and derives no material part of its income, directly or indirectly, from any one or more subsidiary companies which are, a company or companies the principal business of which within the United States is that of a public-utility company; or

"(6) such holding company has only one subsidiary public-utility company and such subsidiary public-utility company's operations as such do not extend beyond the State in which it is organized and States contiguous thereto.

"(b) If a holding company otherwise qualifies for an exemption pursuant to subsection (a) of this section, that exemption shall not be affected by the ownership by a public-utility subsidiary of such holding company of a public-utility company provided that the ownership of such public-utility company by the public-utility subsidiary of such holding company is exempt pursuant to paragraph (2) of subsection (a) of this section.

"(c) The Commission, by rules and regulations upon its own motion, or by order upon application, shall exempt any subsidiary company, as such, of a holding company from any provision or provisions of this title, the application of which to such subsidiary company the Commission finds is not necessary in the public interest or for the protection of investors, if such subsidiary company derives no material part of its income, directly or indirectly, from sources within the United States, and neither it nor any of its subsidiary companies is a public-utility company operating in the United States.

"(d) Within a reasonable time after the receipt of an application for exemption under subsection (a) or (c), the Commission shall enter an order granting, or, after notice and opportunity for hearing, denying or otherwise disposing of such application. The filing of an application in good faith under subsection (a) by a person other than a registered holding company shall exempt the applicant from any obligation, duty, or liability imposed in this title upon the applicant as a holding company until the Commission has acted upon such application. The filing of an application in good faith under subsection (c) shall exempt the applicant from any obligation, duty, or liability imposed in this title upon the applicant as a subsidiary company, until the Commission has acted upon such application. Whenever the Commission on its own motion, or upon application by the holding company or any subsidiary company thereof exempted by any order issued under subsection (a), or by the subsidiary company exempted by any order under subsection (c), finds that the circumstances which gave rise to the exemption no longer exist, the Commission shall by order revoke such order.

"(e) The Commission may, by rules and regulations, conditionally or unconditionally exempt any specified class or classes of persons from the obligations, duties, or liabilities imposed upon such persons as subsidiary companies or affiliates under any provision or provisions of this title, and may provide within the extent of any such exemption that such specified class or classes of persons shall not be deemed subsidiary companies or affiliates within the meaning of any such provision or provisions, if and to the extent that it deems the exemption necessary or appropriate in the public interest or for the protection of investors or consumers and not contrary to the purposes of this title.".

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97TH CONGRESS
1ST SESSION

S. 1871

To amend section 2 of the Public Utility Holding Company Act of 1935.

IN THE SENATE OF THE UNITED STATES

NOVEMBER 19 (legislative day, NOVEMBER 2), 1981

Mr. D'AMATO (for himself and Mr. JOHNSTON) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

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A BILL

To amend section 2 of the Public Utility Holding Company Act of 1935.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 2(a)(5) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79b(a)(5)) is amended by striking out the period at the end thereof and inserting in lieu thereof the following: ", except a gas utility company—

"(A) which owns or operates no facilities described in paragraph (4) of this subsection other than facilities used for the distribution at retail of natural or manufactured gas wholly within a single State; or

"(B) the intrastate gas utility rates of which are subject to regulation by a State authority or authorities of contiguous States.

The exception contained in the preceding sentence shall apply to a gas utility company only if every company which controls, directly or indirectly, such gas utility company either is the issuer of a class of securities registered pursuant to section 12 of the Securities Exchange Act of 1934, or is controlled, directly or indirectly, by such an issuer.".

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II

97TH CONGRESS
1ST SESSION

S. 1977

To repeal the Public Utility Holding Company Act of 1935 as no longer necessary to accomplish the purposes for which it was enacted.

IN THE SENATE OF THE UNITED STATES

DECEMBER 16 (legislative day, NOVEMBER 30), 1981

Mr. JOHNSTON introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

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A BILL

To repeal the Public Utility Holding Company Act of 1935 as no longer necessary to accomplish the purposes for which it was enacted.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

CONGRESSIONAL FINDINGS

SECTION 1. The Congress hereby finds that—

(a) the Public Utility Holding Company Act of 1935 imposes substantial and burdensome requirements upon the holding company sector of the public utility industry. The Act subjects utility holding companies to a level of regulation not found necessary with respect to other organizations in the same or related industries;

(b) the Public Utility Holding Company Act of 1935 continues to impose these requirements even though substantially all of the purposes of the Act have been achieved. Public utility holding companies have been limited to single integrated public utility systems operating in cohesive geographic areas or regions. The simplification of the capital structures of public utility holding companies contemplated under the Act has been completed. Public utility companies organized in holding company systems are not subject to effective Federal, State, and local control, without the regulation of the 1935 Act;

(c) only a small number of public utility holding companies are regulated under the Act. Those that remain regulated under the provisions of the Act are subject to registration and reporting requirements, as well as to other limitations on activities, that are not borne by other companies operating in the utility business, or elsewhere in industry;

(d) existing Federal and State registration and regulatory requirements are fully adequate to insure the protection of investors holding interests in public utility holding companies. The elaborate process of utility registration under the Public Utility Holding Company Act of 1935 afford no greater protection than is afforded by the Securities Act of 1933 and the Securities Exchange Act of 1934. State utility regulatory commissions are now capable under familiar principles of regulatory law to review acquisitions and system transactions entered into by public utility operating companies and their affiliates;

(e) the requirements of the Public Utility Holding Company Act of 1935 are duplicative of other existing Federal and State requirements. State public utility commissions are competent to investigate whether utilities' acquisition of diverse businesses is likely to endanger the reliability of utility service, and are generally empowered to disallow costs charged by companies associated with utility companies which are not in the public interest; and

(f) it is in the public interest to eliminate the provisions of the Public Utility Holding Company Act of 1935 which inhibit innovation. These provisions have retarded the financial health of registered public utility holding companies relative to other companies and utilities. These provisions also provide disincentives to entry into the electric utility generating sector by other industries.

REPEAL OF PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

SEC. 2. The Public Utility Holding Company Act of 1935 (chapter 687, title I, 49 Stat. 803, as amended, codified at 15 U.S.C. 79 to 79z-6 (1976)), is hereby repealed.

REPEAL OF RELATED PROVISION OF THE FEDERAL POWER ACT

SEC. 3. Section 318 of the Federal Power Act (chapter 687, title II, sec. 213, 49 Stat. 863, as amended, codified at 16 U.S.C. 825), providing that any person subject to the requirements of both the Federal Power Act and the Public Utility Holding Company Act of 1935, shall be subject to the provisions of the Public Utility Holding Company Act of 1935, rather than to the provisions of the Federal Power Act with respect to the same subject matter, is hereby repealed.

SAVINGS PROVISION

SEC. 4. This Act shall not be construed to affect any proceedings commenced as of the effective date of these provisions by an official filing with the Securities and Exchange Commission by any company subject to the provisions of the Public Utility Holding Company Act of 1935.

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Department of Energy
Washington, D.C. 20585

June 14, 1982

Honorable Alfonse M. D'Amato
Chairman, Subcommittee on Securities
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

On June 8 and 10, 1982, the Securities Subcommittee held hearings on S. 1869, S. 1870, S. 1871, and S. 1977, bills to amend or repeal the Public Utility Holding Company Act of 1935.

A statement for the record which presents the Administration's views on the proposed bills is enclosed for your consideration.

The Office of Management and Budget has advised that the views expressed herein are in accord with the program of the President.

Sincerely,

Rob Odle

Robert C. Odle, Jr.
Assistant Secretary for
Congressional, Intergovernmental
and Public Affairs

Enclosure

STATEMENT OF
J. HUNTER CHILES, III
DIRECTOR, POLICY, PLANNING AND ANALYSIS
U. S. DEPARTMENT OF ENERGY

Mr. Chairman, Members of the Subcommittee:

I am J. Hunter Chiles, III, Director, Office of Policy, Planning and Analysis, Department of Energy. I appreciate the opportunity to appear before you today to present the views of the Administration on the Public Utility Holding Company Act of 1935 (hereinafter the 1935 Act). The Administration views the 1935 Act as another regulatory mechanism from a bygone era that has served its purpose. Today, it does nothing more than create a regulatory burden for the electric and gas utility industry from which little or no benefits are gained. As a result, the Administration supports S. 1977, which would repeal the 1935 Act. The Administration does not support the three bills, S. 1869, S. 1870, and S. 1971, either individually or collectively, which would modify the 1935 Act so substantially that the end result would be tantamount to repeal but would leave the Securities and Exchange Commission (SEC) with the chimera of regulatory authority. I would like to state the reasons for the Administration's position succinctly and leave with the Subcommittee an attachment to my statement which provides more detail.

Administration Position

The Administration's position is founded upon the following premises:

1. The industry environment justifying the 1935 Act is no longer present. The 1935 Act was enacted in an era of wildly speculative

business schemes and massive securities frauds. The entire economy was in the throes of such schemes, not only public utilities. Many acts were passed to safeguard investors; the 1935 Act was only one of them.

2. Present laws duplicate much of the 1935 Act, making it redundant, and adding needlessly to the regulatory burden of the electric and gas utility industries. The SEC relies upon other laws, namely, the securities acts of 1933 and 1934, and not the 1935 Act, to regulate securities transactions and protect investors. The accounting standards required by the 1935 Act have become virtually universal, required by the SEC under its other statutory authority, by the Federal Energy Regulatory Commission (FERC), by the state regulatory commissions, and by the accounting profession. Intercompany transactions, now regulated by the 1935 Act, are or can be regulated by FERC and by state regulatory commissions. Corporate acquisitions, now regulated by the 1935 Act, are covered by the antitrust laws, and enforced by the Department of Justice, the Federal Trade Commission, and through private suits. The only activity covered by the 1935 Act and not covered elsewhere are the corporate and geographic simplification provisions. But here again the 1935 Act has served its purpose. The 216 holding companies registered with the SEC since 1935 have undergone SEC scrutiny so that today only 12 active registered systems remain. The SEC has not held a simplification proceeding for at least 20 years. The industry complexity justifying this form of regulation has disappeared.

3. The 1935 Act intrudes into management decisionmaking and restricts the flexibility of management to develop corporate strategies that maximize the efficiency and welfare of the company, its ratepayers, and its investors. The 1935 Act requires companies to file for approval for a myriad of intra- and intercompany transactions that normally are the province of management without second guessing by the government.

4. The 1935 Act is an obstacle to diversification efforts by registered holding companies and exempt companies. The language of the statute prevents registered companies from acquiring functionally unrelated businesses. The ability of the SEC to revoke exemptions from registration has a chilling effect upon exempt companies in their diversification pursuits. The fear of coming under the registration requirements of the 1935 Act has stopped industrial entrants into some parts of the electric power industry.

While the Administration supports repeal of the 1935 Act because it is a regulatory anachronism and burden, the issue that is engendering the most concern is utility diversification. Consumers and state regulatory commissions worry that a holding company embarking upon a diversification strategy will affect the utility operating company in a host of adverse ways, including draining utility assets, diverting management attention and skills, making bad investments that have a negative impact on the operating company, and generally bleeding the utility to the detriment of ratepayers but to the benefit of stockholders. Others have voiced the concern that diversification by utilities into nonutility businesses can be inefficient and anticompetitive, that is, it is a method of evading rate regulation by charging excessive intercompany transfer prices between the regulated and nonregulated companies. These concerns may be legitimate. But the 1935 Act is not the vehicle to deal with these concerns. It is poorly designed to deal with them and may be creating an illusion that protection exists at the federal level when there is no real protection.

Without taking a position on the benefits or detriments of diversification of a particular utility into nonutility businesses, the Administration believes that there are better ways to deal with the issue than through the retention of the 1935 Act. The states are grappling with the utility diversification issue at the moment. That is where the issue should generally be dealt with, at the state level where the resources of the state commission can be focused to deal with the unique situations posed by each company. A broad brush federal statute such as the 1935 Act does not allow for the careful formulation of rules to deal with the individuality of companies. Moreover, the 1935 Act does not preempt state efforts. States are now free to enact legislation or promulgate rules concerning diversification and several have done so or are considering such steps. Finally, the 1935 Act's applicability to diversification is very limited. Its strictures concerning acquisitions of functionally related businesses cover only twelve holding companies. While over 80 exempt companies are in the precarious position that exemptions may be revoked, the 1935 Act apparently has not held back those companies desiring to diversify. This leaves the federal regulatory scheme confused and discriminatory. It provides very limited protection to consumers and the states.

The Administration supports repeal of the 1935 Act and believes the issue of diversification should be addressed outside the scope of the current regulatory scheme. This does not preclude efforts by any state to address the diversification issue. In this regard, the Administration would insert into any legislation that repeals the 1935 Act a provision which stays the effective date of the legislation for two years to give the states time to consider whether any additional legislation is required.

Conclusion

The Administration strongly supports the repeal of the 1935 Act. Its justification is no longer applicable in today's environment. It is redundant and burdensome to the utility industry. It limits management flexibility and efficiency. It hinders diversification. Its benefits appear minimal compared to its regulatory costs.

This concludes my oral statement. I am available for any questions that you may have.

Attachment to DOE Statement

This Attachment provides some more detail supporting the Administration's position.

The 1935 Act

The 1935 Act is a regulatory statute in addition to being a disclosure statute. It is aimed at financial transactions, corporate structures, acquisitions and dispositions of assets, and potential conflicts of interest.

The 1935 Act requires that all holding companies with subsidiaries engaged in any aspect of the electric utility business or in the retail distribution of natural gas register with the SEC. Twelve holding companies fall within this registration provision. Nine are electric utility systems and three are gas utility systems. In 1981, gross revenue terms, the nine electrics represent about 20 percent of the investor-owned electric utilities, and the three gas companies represent about 8 percent of the gas utility industry.

Once a holding company registers, it becomes subject to two principal kinds of regulation: the geographical integration and corporate simplification process, and the various regulations concerning financial and operational aspects of the holding company system, including transactions with affiliated entities. The integration and simplification process of section 11 provides a method for the SEC to examine the corporate structure of each registered holding company. During this examination, the SEC must determine the extent to which the structure should be simplified, e. g., eliminate pyramid holding companies, and the business geographically integrated, e. g., eliminate companies that are not geographically contiguous. The integration process was designed to limit the operations of the company to a single integrated electric or gas utility system with only "such other businesses as are reasonably incidental, or economically necessary or appropriate to the operations of [the] . . . system." Integrated operations are specifically defined in the statute as a means of providing guidance to the SEC in its determinations (See section 2 of the 1935 Act.)

Section 11 of the 1935 Act permits a registered holding company to retain any nonutility business only if it is "reasonably incidental, or economically necessary or appropriate to the operations" of the utility system based upon a public interest standard. Through court interpretations of the statutory language, this has become known as the "functionally related" test for nonutility acquisitions.

Once the registered holding company has been simplified, it must comply with the many other provisions which include review of securities issuances, proxy solicitations, accounting practices, intrasystem transactions including intercompany loans, dividends, capital contributions, acquisitions by companies of their own securities, service company operations and services rendered by affiliates, and sales and acquisitions by holding companies of utility assets or of securities of utility companies.

While only 12 companies presently are registered under the 1935 Act, about 80 companies are exempt from the 1935 Act. These companies primarily are intrastate operations. A company that meets the exemption criteria is exempt "unless and except insofar as [the Commission] finds the exemption detrimental to the public interest or the interest of investors or consumers." This is the so-called "unless and except" clause, which gives the SEC the power to revoke the exemption. While the SEC has not revoked the exemption of any company in recent memory, it came close to imposing a series of restrictive guidelines on the types of investments that an exempt company could make. The threat of future SEC action creates a chilling atmosphere on the management prerogatives of the exempts.

The Industry Environment Justifying the 1935 Act No Longer Exists

The 1935 Act was passed in an era of wild speculation that pervaded the entire economy and not only the utility sector. The growth of the utility sector during the 1920s was phenomenal, generating skyrocketing profits. The boom mentality which pervaded the 1920s combined with an almost insatiable demand by small investors for anything labeled "utility stock" created a classic speculative bubble. This bubble burst with the onset of the depression leaving a number of holding companies in bankruptcy.

The speculation of the 1920s occurred in an environment of very limited state and federal regulation of utilities. The SEC was not formed until 1933. As late as 1935, there were only 22 states that regulated electric utility rates, while more states regulated entry. The legislation establishing the 1935 Act also introduced regulation of interstate electricity sales. Therefore, with little regulation on either the state or federal level, a public willing and eager to invest, and a rapidly expanding industry with great mystique, the stage was set for the type of abuses that occurred.

Holding companies, while initially serving a useful purpose by giving local utilities access to national capital markets, soon became vehicles for abuses. Stock was watered and companies were pyramided so that by 1929 the aggregated value of utility holding company securities was estimated at $19 billion which represented an investment of no more than $3 billion in capital plant and equipment. The difference between the two sums went to line the pockets of bankers, speculators, and corporate insiders.

There is a well documented history of abuses that led to the passage of the 1935 Act. It is clear, however, that the abuses prevalent in the 1920s do not exist today. As a result, it is appropriate to examine the 1935 Act to determine whether it is still necessary.

The 1935 Act Is Redundant and Burdensome

The environment in which the utility industry operates today is vastly different from the go-go days of the 1920s. The industry is encumbered with layer upon layer of state and federal regulation that makes it impossible for the industry to repeat the abuses of the 1920s. The level of market sophistication is such that the pervasive schemes rampant in the 1920s would fall on deaf ears today. The many institutional structures, other than the 1935 Act, are sufficient to protect consumers, ratepayers, and investors.

At the federal level, there are the following laws that regulate and protect:

- Securities Act of 1933 and Securities Exchange Act of 1934: The SEC relies upon these Acts and their amendments as its authority for regulation of all companies concerning securities disclosure, accounting standards, affiliate transactions and other securities practices. The 1933 and 1934 Acts provide extensive protection for investors through detailed disclosure requirements and vigorous SEC enforcement. The SEC has used its authority under these Acts to require accounting standards for the form and content of financial statements.

- Federal Power Act: This Act gives the FERC the power to approve securities issuances to the extent not regulated by states. The Federal Power Act also authorizes standard accounting practices.

Affiliate transactions are covered by various provisions of the Federal Power Act and the 1933 and 1934 Acts. FERC's authority to set wholesale rates gives it the ability to examine the amounts paid to affiliates and to disallow expenses that are unreasonable. The disclosure requirements of the 1933 and 1934 Acts, plus the accounting standards established since 1935, combine to inhibit the recording of such transactions other than honestly and fairly.

- Antitrust laws: The antitrust laws are available to protect against the 1935 Act's strictures against undue concentration of control. The Department of Justice recently has indicated its concern over various forms of acquisitions that lead to inefficient and anticompetitive results in the electric power and natural gas utility industries. The antitrust laws are more than adequate to cope with such situations on a case-by-case basis.

- Federal Election Campaign Act and Federal Regulation of Lobbying Act: These laws protect the public in the same manner that the 1935 Act does.

At the state level, each state has a regulatory commission that regulates electric and gas utilities. For example, all states regulate retail rates. Forty-five states specifically require state regulatory commission approval prior to the issuance of securities. Most require uniform accounting standards. Over forty deal with intercompany transactions in some manner.

Finally, unsound financial transactions are much more difficult to perpetrate in today's marketplace. There are many actors in the financial marketplace that place great regard for their reputations upon their financial evaluations. Investment bankers derive much of their business from reputation. The same is true of financial analysts and rating services. Poor evaluation and hiding of unsound financial practices would affect their reputations adversely and the confidence of institutional and individual investors would diminish. Thus, the general level of investor sophistication requires that careful analysis be given to the financial evaluations performed by bankers, analysts, and rating services.

Management Decisionmaking

Various parts of the 1935 Act inject the SEC into the decisionmaking process of utility management. This detracts from the ability of the management to deal efficiently or flexibly with its internal strategic planning. The subjects which come under the 1935 Act's purview include: intercompany loans, indemnification of or lending of credit among companies, dividends, sale of outstanding securities and assets, proxies, and service, sales, and construction contracts.

Only the 12 companies registered under the 1935 Act have to comply with these provisions. The approval process is costly in terms of time and money. It usually takes at least 60 days to obtain a determination from the SEC on these various transactions. In the interim, circumstances can change sufficiently for the transaction to fall through, impairing the company substantially.

Other requirements imposed under the Act may adversely affect utility financing. For example, requiring marketing of securities through competitive bids, prevent negotiated sales, which may benefit the utility more than competitive sales of securities. There also are restrictions concerning first mortgage bonds that may make financing more costly. There is no doubt that the flexibility of management is hindered by various provisions of the 1935 Act that either are redundant or burdensome without any justification.

Utility Diversification

Without taking a position on the attributes or detriments of diversification of a particular utility into nonutility businesses, we believe the issue of diversification should be addressed outside the scope of the current regulatory scheme. It is clear that now utilities have differing abilities to diversify. Registered companies are the most restricted. Exempt companies diversify at their peril with the sword of Damocles hanging over their corporate heads in the form of potential SEC revocation of their exemption. Nonutility companies fear that entry into aspects of the utility business may expose them to registration under the 1935 Act. For example, a company desiring to enter into electric power generation may find itself subject to the 1935 Act depending upon the interpretation given the 1935 Act by the SEC.

Additionally, the states are grappling with the utility diversification issue at the moment. While each state may want to regulate in different ways, they can do so now even with the 1935 Act in place, and several have done so. The 1935 Act is only very limited protection to the states.

In this regard, any legislation that repeals the 1935 Act ought to include a provision which stays the effective date of the legislation for two years to give the states the time to consider whether any additional legislation is required.

Senator D'AMATO. Congressman Tauzin.

STATEMENT OF W. J. TAUZIN, REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Representative TAUZIN. Thank you, Mr. Chairman.

Let me echo the words of my colleague in commending you, Mr. Chairman, and your committee for examining this very important area of utility law. We're very anxious to have the issue heard and debated on the House side and I think your actions have helped us greatly in achieving an agreement by the chairman on the House side for hearings for which we thank you greatly.

UNNECESSARY REGULATIONS

Let me also point out, sir, that this is rather an extraordinary opportunity for the Congress. We often speak of the chance to undo unnecessary, duplicative, burdensome regulation that accomplishes no useful purpose in our society. Yet we have very few opportunities to actually undo and remove some of that unnecessary regulation that has accomplished its purpose and is now still somehow left in the law to interrupt and interfere with our activities as a Nation. Here's a chance.

I think it's also useful to point out, Mr. Chairman, that the unanimous decision by the SEC with no abstentions to recommend the repeal of PUHCA is also very interesting in light of the fact that the SEC is another agency of our Government which is struggling under the budgetary restraints to justify its operations, and for a regulatory agency of our Government during this period of struggle for budgets and for dollars to come forward with a recommendation for repeal of one of its functions is an extraordinary act and certainly enhances, I think, the rationale for repeal.

It certainly makes the case stronger I think when you consider that this regulatory body is conceding that this system of regulation is no longer needed in our society. There are ample other forms of regulation to deal with the problem initiated in this Act.

Mr. Chairman, I also have a statement for the record which I will submit. Let me perhaps summarize it.

Senator D'AMATO. Certainly.

Representative TAUZIN. Mr. Chairman, on February 4, I introduced H.R. 5465, which is similar to the Senate bill before you today, calling for the elimination of the Public Utility Holding Company Act of 1935.

As the unanimous statement of Chairman Shad's letter of December 4 indicates to you, the central purposes of that 1935 act enacted 47 years ago have now been achieved and the act has outlived its usefulness and certainly should be repealed.

The few public utility holding companies that are still subject to the provisions of the act are not the complex, farflung entities that avoided the State and local regulations in the 1920's and 1930's. The Federal and State utility and securities laws now provide adequate protection for investors and for consumers and customers of public utility holding companies. Yet the act of 1935 still imposes a series of duplicative Federal controls on utility holding companies and their service and operating affiliates which are far more onerous than those imposed upon utilities which do not operate under the holding company form of organization or, indeed, those imposed upon any other industry.

The products of a regulatory system first conceived in an entirely different economic climate are completely unjustified today. Repeal would free an important segment of the utility industry from unnecessary layers of Federal regulation. Furthermore, repeal would restore equity to the utility industry by placing holding companies on an equal footing with other utility organizations and with industrial companies not burdened with the regulation of the 1935 act.

The purposes for which the Public Utility Holding Company Act of 1935 were enacted were certainly laudable. If we look back in history we'll see that in 1935 investors could not obtain the earnings information they needed to appraise the financial position or the earning power of the public utility holding company. Accounting procedures were not standardized then. They were better suited to confusion rather than to clarification. State regulatory bodies were unable to exert fully effective control over the complex, widely diversified public utility holding companies that were then in existence. The securities of those companies they issued were incomplete, misleading information that were offered on face value that bore no relationship to the earning capacity of the properties held by the utilities company. Transactions were entered into for no justifiable business purpose. The capital structures of many of the companies were unsound.

This has all changed. Utilities organized in holding company systems are now basically no different than the multi-State utilities. Were it not for their historic form of organization, they—like other utilities and industrial companies—would not be subject to the antequated requirements of the act.

Again, the main purpose of the act has been fully accomplished. Today utilities organized in holding company form are indeed amenable to State oversight and regulation. To the extent that some of the utility companies operate across State lines, various requirements imposed by the Federal Power Act, the Natural Gas Act administered by the Federal Energy Regulatory Commission are fully adequate to insure uninterrupted operation and reasonable rates for electricity and gas moving in interstate commerce.

REPEAL JUSTIFIED

As Chairman Shad's letter of December 21, 1981, so eloquently argues, the regulators themselves recognize that the reorganization and simplification process mandated under the 1935 act has been accomplished and the act should now be repealed.

I'd like to focus just for a second on the business regulation aspects of the act. There's no reason any longer to place the Securities and Exchange Commission in the position of second-guessing the business decisions made by a public utility holding company. Under current law a public utility holding company must seek SEC approval for such transactions as long-term security offerings, sale of utility assets, letting of contracts to affiliates, acquisitions of assets and securities of other operating utility company.

The approval of State regulatory commissions is already required prior to SEC approval of the holding company utility's offering and acquisition of securities and utility assets of other utility companies. There's no more any reason to superimpose Federal regulation of the utilities organized in holding companies on top of regulation already accomplished by the State. The Federal Energy Regulatory Commission should not treat them any differently than industries and utilities.

While regulation of public utility holding companies does not accomplish much of anything that is not achieved under existing authority at the State and Federal level, regulation does indeed hamper utility holding companies in their efforts to enhance their economic position, to improve their efficiency by combining into productive units, and pooling their credit and to move into areas which will improve their overall financial stability.

I might add, Mr. Chairman, when we inhibit the efficiency of utility companies to perform their function for the public, we of course cause increases of utility rates and loss of services on occasion.

The burdensome regulatory requirements imposed by the SEC under the act additionally provide a substantial disincentive to entry by industrial entities into the electrical generation business. These requirements also discourage combinations of utilities which could similarly result in economies of scale, improved economic efficiency, and broad joint ownership of new plant.

I want to point out one case in point Senator Johnston mentioned, the problems the public utilities have in the securities market. Because of the time lag he mentioned presented by the competitive bidding procedures by which the public utilities must seek underwriters assistance and because of the uncertainty that accompanies an underwriter's look into the fairly distant future, underwriters bidding on regulated holding companies in the securities offerings are often forced to increase their bids to protect themselves against the risks that they will be required to handle an offering at a time when the market is soft. As Senator Johnston so adequately pointed out, the market is indeed volatile in this area. Underwriters engaging in negotiated transactions confront a much shorter time horizon and accordingly they feel no need to hedge against an uncertain future market.

The effects of this then, for example, is to reduce the efficiency of financing at a time when utilities and the economy can scarcely afford unnecessary costs like this. Regulated utility holding companies must compete in capital markets with utilities as well as members of other industries that are not hamstrung by these costly, inefficient and largely useless rules. It is undeniable that with respect to financing, regulated utility holding companies are treated inequitably.

Mr. Chairman, Congress has an opportunity in this case to eliminate a regulatory system that performs no useful function any longer, that exacts high costs upon the regulated industry, and duplicates other applicable regulatory authority. This is an excellent opportunity for us to put into practice what we have preached so long, to undo unnecessary, duplicative Federal regulation. Accordingly, I urge you and your colleagues and I hope the whole Congress to approve S. 1977 and repeal the Public Utility Holding Company Act. Thank you, Mr. Chairman.

[The complete statement follows:]

STATEMENT OF CONGRESSMAN TAUZIN

Representative TAUZIN. Mr. Chairman, on February 4 of this year, I introduced H.R. 5465, similar to S. 1977 proposing to eliminate a regulatory system that has outlived its usefulness, the Public Utility Holding Company Act of 1935. The act imposes substantial and burdensome structural limitations, registration requirements and ongoing reporting and preclearance obligations upon holding companies operating electrical generating or gas transmission utilities. These regulatory requirements admirably served their purpose for a time, and resulted in the corporate simplification and geographical integration of public utility holding companies. This act, together with the Securities Act of 1933 and the Securities and Exchange Act of 1934 and State utility regulation largely eliminated the sorts of business practices that had led to abuses of economic and political power by large utility organizations which, in 1935, could not successfully be controlled by State and local regulatory authorities.

As the unanimous Securities and Exchange Commission pointed out to you in Chairman Shad's letter of December 4, 1981, the central purposes for which the Public Utility Holding Company Act of 1935 was enacted 46 years ago have by now been achieved and the act should be repealed. The few public utility holding companies still subject to the provisions of the act are not the complex, far-flung entities that avoided State and local regulation in the 1920's and the 1930's. The Federal and State utility and securities laws now provide adequate protection for investors in, and customers of, public utility holding companies.

Yet the Public Utility Holding Company Act of 1935 still imposes a series of duplicative Federal controls on utility holding companies and their service and operating affiliates which are far more onerous than those imposed upon utilities which do not operate under the holding company form of organization or, indeed, than those imposed upon any other industry. The holding companies still subject to the provisions of the act continue to be required to file registration statements which largely duplicate registration statements they would file in any event under the Federal securities laws. They continue to be required to report and obtain clearance for business transactions that are already subject to close scrutiny by State regulatory bodies and by the Federal Energy Regulatory Commission.

Despite these substantial burdens, the public utility holding companies regulated under the act must compete in capital markets with companies not subject to similar limitations. At the same time the provisions of the Public Utility Holding Company Act present strong disincentives to entry into the generation of electricity where such entry would be accomplished under the holding company form of organization. Exempt holding companies are faced with revocation of exemptions under the section 3 "unless and except" clause.

These products of a regulatory system first conceived in an entirely different economic climate are completely unjustified. Repeal of the Public Utility Holding Company Act would free an important segment of the utility industry from unnecessary, unproductive, and duplicative layers of Federal regulation. Furthermore, repeal would restore equity to the utility industry by placing holding companies on an equal footing with other utility organizations, and with industrial companies not burdened with regulation under the 1935 act.

The purposes for which the Public Utility Holding Company Act of 1935 was enacted in 1935 were certainly laudable. As of 1935 investors could not obtain the information they needed to appraise the financial position or earning power of public utility holding companies. Accounting procedures were not standardized and were better suited to confusion than to clarification. State regulatory bodies were unable to exert fully effective control over the complex and widely diversified public utility holding companies then in existence. The securities of such companies were issued on the basis of incomplete or misleading information and were offered at face values that bore no relationship to the earning capacity of the properties held by the utility companies. Transactions were entered into for no justifiable business purpose. The capital structures of many of the utility holding companies were unsound.

This has changed. Utilities organized in holding company system are now basically no different from other multi-State utilities; were it not for the accident of their form of organization, they, like other utility and industrial companies, would not be subject to the antiquated requirements of the act. The main purposes of the Public Utility Holding Company Act have been accomplished.

SIMPLIFICATION

The simplification of holding companies' corporate structures and the limitation of holding company operations to specific geographic areas has long since been achieved, as is noted in the 1977 General Accounting Office, Report to the Congress, "The Force of the Public Utility Holding Company Act has been Greatly Reduced by Changes in the Securities and Exchange Commission's Enforcement Policies." The pyramiding of control and costs formerly exercised through several tiers of subsidiary companies and through complex interlocking arrangements has been narrowed. Public utility operations are now for the most part confined to contiguous States.

In accordance with the purposes of the Public Utility Holding Company Act, utilities organized in the holding company form have been now made amenable to State oversight and regulation. To the extent that some utility holding companies operate across State lines, various requirements imposed by the Federal Power Act and the Natural Gas Act administered by the Federal Energy Regulatory Commission are fully adequate to insure uninterrupted operation and reasonable rates for electricity and gas moving in interstate commerce.

As Chairman Shad's letter of December 21, 1981, so eloquently argues, the regulators themselves recognize that the reorganization and simplification process mandated under the Public Utility Holding Company Act has been accomplished, and the act should be repealed.

REGISTRATION

The registration requirements of the Public Utility Holding Company Act are also no longer necessary. No public utility holding companies have made initial 1935 Act registrations in some time. The ongoing reporting requirements as well as the rules concerning insider trading and proxy solicitation imposed under the act afford no greater protection than is provided by the Securities Act of 1933, the Securities Exchange Act of 1934 and States securities laws. These requirements of the 1935 act are essentially duplicative and can be repealed without any adverse effect on the ability of investors to gain the information required to assess financial strength and earning power. Where the Securities and Exchange Commission currently dictates the content of mortgage bond indentures, stock charters and other instruments, State utility and securities regulatory agencies could provide whatever regulation and supervision is necessary. Given the fact that the information currently required under the Public Utility Holding Company Act is available elsewhere, and is normally utilized by other agencies in performing their regulatory functions, the imposition of these burdensome reporting and recordkeeping requirements is totally unjustified.

BUSINESS REGULATION

Additionally, there is no longer any reason to place the Securities and Exchange Commission in the position of second-guessing the business decisions made by public utility holding companies. Under current law, utility holding companies must seek SEC approval for such transactions as long term security offerings, sales of utility assets, letting of contracts to affiliates, and acquisitions of assets and securities of other operating utility companies. The approval of State regulatory commissions is already required prior to SEC approval of holding company operating utility securities offerings and acquisition of securities and utility assests of other operating utility companies. There is no longer any reason to superimpose Federal regulation of utilities organized in holding companies on top of regulation already accomplished by the States, and the Federal Energy Regulatory Commission nor to treat them differently from other utilities or industries.

While regulation of public utility holding companies does not accomplish much of anything that is not achieved under existing regulatory authority both at the Federal and State levels, that regulation does hamper utility holding companies in their efforts to enhance their economic position, improve their efficiency by combining into productive units and pooling their credit, and to move into areas which will improve their overall financial stability. The burdensome regulatory requirements imposed by the Securities and Exchange Commission under the act additionally provide a substantial disincentive to entry by industrial entities into the electric generating business. These requirements also discourage combinations of utilities which could similarly result in economics of scale, improved economic efficiency and broad joint ownership of new plant.

Finally, in its current state, our economy can hardly afford continued regulatory interference where that interference produces no benefits that are not already assured by other applicable regulations. For this reason, we should question the wisdom of continuing to require a small number of utility holding companies to bear an inequitable burden as compared with exempt holding companies, utilities that have not been organized as holding companies, or other industries.

Utility holding companies that are burdened by the clearance, recordkeeping and investment limitations of the Public Utility Holding Company Act still must compete in financial markets against companies not similarly hindered. Furthermore, we must question whether the provisions of a 1935 law intended to protect the interests of investors have any further validity. Because so few utility holding companies remain subject to the Public Utility Holding Company act, the protection of investors supplied by the 1935 act, over and above the safeguards of the 1933 Securities Act and 1934 Exchange Act, is illusory. Few investors actually realize whatever benefits are provided by the redundant registration and disclosure requirements of the act. In any event, they are more than adequately protected by the Federal securities laws.

I believe it is clear that virtually none of the rationales advanced in support of the Public Utility Holding Company Act in 1935 remain vital today. Even though its application has been greatly reduced, the Public Utility Holding Company Act continues to produce more than its fair share of frustration among the regulated.

For instance, all registered utility holding companies face a serious problem in undertaking special financing programs. Under SEC rules intended to implement the Public Utility Holding Company Act, regulated holding companies must select underwriters to handle securities offerings only through complicated competitive bidding procedures. Regulated holding companies are specifically precluded from entering into the types of negotiated transactions with underwriter groups that are commonplace in financing arrangements made in all order sectors of American industry.

Because of the time lag presented by competitive bidding procedures and the uncertainty that accompanies an underwriter's look into the farily distant future, underwriters bidding on regulated holding company securities offerings are forced to "increase" their bids to protect themselves against the risk that they will be required to handle an offering at a time when the market is soft. Underwriters engaging in negotiated transactions confront a much shorter time horizon, and accordingly they generally feel no need to hedge against an uncertain future market.

The effects of this rule are to reduce efficiency in financings at a time when the utilities and our economy can scarcely afford unnecessary costs. Regulated utility holding companies must compete in capital markets with utilities as well as members of other industries that are not hamstrung by these costly, inefficient and largely useless rules. It is undeniable that, with respect to financings, regulated utility holding companies are treated inequitably.

I believe that it is time to recognize that the Public Utility Holding Company Act no longer operates to further the public interest. Its requirements largely duplicate the requirements imposed by other Federal laws and by State regulatory agencies. It provides no meaningful protection for investors in companies remaining subject to the act that is not provided in other ways. It imposes substantial and inequitable regulatory burdens on a small segment of the overall utility industry.

The act has retarded the development of utility companies that have adopted the holding company form of organization. Those companies are hampered in the efforts to operate in the difficult climate faced by all utility companies by a statute designed in 1935 to deal with problems that have long since ceased to exist.

The bill to repeal the Public Utility Holding Company Act of 1935 would free a segment of the utility industries from an unnecessary, unproductive and duplicative layer of Federal regulation. It would permit oversight of registered utility company activities to be left to the FERC and the State and local entities which currently supervise all other public utility operations. Those bodies are in the best position to see that the interests of consumers are properly safeguarded. Investors are far better protected today under other Federal securities laws that they were in the 1920's and early 1930's.

It is time for this Congress to recognize that public utilities organized in holding companies are now susceptible to State supervision. For this reason alone the assumptions that led Congress to enact the Public Utility Holding Company Act in 1935 have ceased to be valid. We should acknowledge that we have here an example of regulatory authority that is needless, burdensome, and outmoded.

I urge that this Congress take this opportunity to eliminate a regulatory system that performs no useful function, exacts high costs upon the regulated industries and duplicates other applicatory regulatory authority. Accordingly, I urge that S. 1977 to repeal the Public Utility Holding Company Act of 1935 be favorably acted upon.

Senator D'AMATO. Congressman Tauzin, let me commend you for the cogency and the eloquence of your presentation. I just wish we had more members of the committee here to hear your words. I hope their staff will pass on to them your thoughts. If we hope to attract the necessary capital in the utility industry—and I think it's so important for us as a nation to do so, so that we can have the best generating facilities, so that we can develop the alternative energy sources that are so necessary—why, then, I believe we must seriously consider at the very least, the kind of amendments that will promote capital formation, that will allow some diversification, and that will enhance the possibility of attracting new investors into this area. I want to commend both my colleagues in the Congress and thank you for taking your time to contribute to the subcommittee's hearings and to our deliberations. We look forward to working with you on this important legislation. And I think it is very important, and an issue that has not received adequate attention.

I hope we'll have an opportunity to do something in this area, and maybe we'll surprise some people. Thank you very much for your testimony.

I call the first panel: Solomon Freedman, Counsel, Davis & Cox in Washington; and Charles Benore, first vice president, Paine Webber, Mitchell & Hutchins, Inc., New York.

Mr. Freedman, how are you this morning?

Mr. FREEDMAN. Very fine, thank you, Senator.

Senator D'AMATO. Mr. Freedman, I'm wondering if in addition to your prepared statement, you might summarize for the record your background which so eminently qualifies you to give testimony here this morning.

STATEMENT OF SOLOMON FREEDMAN, COUNSEL, DAVIS & COX, WASHINGTON, D.C.

Mr. FREEDMAN. Thank you, Mr. Chairman. I'll start in 1942. There's no point in going back before that.

Senator D'AMATO. I think that's adequate.

Mr. FREEDMAN. I joined the staff of the then Public Utilities Division of the Securities and Exchange Commission in 1942. That division helped the SEC administer the Holding Company Act. I became Assistant Director in either 1951 or 1952 and Associate Director in 1961 and Director of the Division with its name changed and with additional functions that the Commission gave it in 1964, and I resigned from the Commission in 1972. So for 30 years, I was deeply involved in the administration of this act and I'm proud of the accomplishments of the Commission.

Incidentally, I think I ought to say that neither I nor my firm of which I am of counsel represents any public utility, any public utility holding company, any public power, any cooperative. We don't represent anybody that would be affected by this proposed bill.

Now, as background, the Public Utility Holding Company Act of 1935—and, incidentally, we don't call it PUHCA. We call it the Holding Company Act.

Senator D'AMATO. Henceforth, it shall be known as the Holding Company Act.

Mr. FREEDMAN. Or the act.

Senator D'AMATO. All right. We'll simplify it. For the balance of these hearings, it shall be noted that it shall be known as the act.

Mr. FREEDMAN. It was enacted as the consequence of two investigations of the electric and gas utility companies—one by the Federal Trade Commission upon the direction in 1928 of the Senate, and the other by the House Committee on Interstate and Foreign Commerce. A description of the studies made are set forth in section 1(b) of the act.

STRUCTURE OF THE ACT

Now so that the committee may understand what this statute is about and as background in considering some of the statements that have been made and will be made concerning how the act operates concerning the acquisition of assets by companies and holding company systems and the issuance of securities and the purchase of securities by companies in holding company systems, I should like to advise the committee as to the structure of this act.

The act is basically concerned with only certain kinds of public utilities: (1) electric utility companies and (2) gas utility companies. An "electric utility company" is defined as "any company which owns or operates facilities used for the generation, transmission, or distribution of electric energy for sale" (Sec. 2(a)(3)). A "gas utility company" is defined as "any company which owns or operates facilities used for the distribution at retail . . . of natural or manufactured gas for heat, lights, or power" (Sec. 1(a)(4)). Thus, a natural gas pipeline company is not a gas utility company.

If a company owns or holds 10 percent or more of the voting securities of a public utility company, it is a holding company (Sec. 2(a)(7)), and any company 10 percent or more of whose voting securities are owned or held by a holding company is a "subsidiary company" of such holding company (Sec. 2(a)(8)).

Section 3 relates to the granting of exemptions to certain kinds of holding companies, and I noticed that some of the bills propose to amend and grant additional exemptions and to amend the present provisions relating to the requirements to obtain an exemption. Section 4 makes it unlawful, unless it registers as a holding company pursuant to section 5, to, among other things, for it or any subsidiary thereof, to transmit electric energy or distribute gas in interstate commerce, or to offer or sell any security by means of the mails or any instrumentality of interstate commerce.

Sections 6 and 7 concern the issue and sale of securities by any holding company or subsidiary company thereof. A company which desires to issue or sell any security must file a declaration with the Commission for such issue and sale and, before it may sell such security, the Commission must enter an order permitting the declaration to become effective. Section 7 sets forth the standards which must be satisfied before the Commission may permit the declaration to become effective. Among these standards is section 7(d) which requires the declaration to be denied if the security is not reasonably adapted to (a) the security structure of the declarant and other companies in the same holding company system; and (b) the earning power of the declarant.

Section 6(b) requires the Commission to permit, subject to terms and conditions, the declaration of a public utility company to become effective if the State commission where such company is organized and doing business expressly authorizes the issuance and sale. Thus, while it is recognized that a State public utility commission has appropriate jurisdiction with respect to securities issued by local public utilities, it is also recognized that a State commission has no jurisdiction as to holding companies. Only the SEC has such jurisdiction. Thus, since at least three of the present gas utility holding company systems finance their operations solely at the holding company level, and no public utility company subsidiary issues and sells securities, no State commission has any jurisdiction over such issuances and sales.

Under section 7(f) the Commission may impose terms and conditions to the issue and sale of the security. Under this section, and the correlative section 6(b) (which concerns securities of public utility companies authorized by a State public utility commissioner), the Commission in 1941 adopted the competitive bidding rule for the sale of securities, and the Commission in 1956 adopted minimum standards required for the protection of investors, to be included in first mortgage bond indentures and preferred stock charters.

[Complete statement of Mr. Freedman follows:]

STATEMENT OF SOLOMON FREEDMAN

BACKGROUND

The Public Utility Holding Company Act of 1935 was enacted as a consequence of two investigations of the electric and gas utility companies—one by the Federal Trade Commision upon the direction in 1928 of the Senate, and the other by the House Committee on Interstate and Foreign Commerce.

The Federal Trade Commission report consisted of some 90 volumes and has been said to be the most exhaustive study, at least up to that time, of any industry. The House Committee report constituted six volumes.

These studies uncovered a number of abuses in holding company systems: (1) the holding company was used to acquire control of operating public utility companies with the holding company issuing its senior securities to the public and the promoters retaining the voting securities. As a result the holders of the common stock of the top holding company, with a relatively small investment, controlled all the utilities companies, (2) holding company was piled on top of other holding companies with each tier issuing its own senior securities so that all the senior securities in each tier were dependent entirely on the common stock earnings of the public utilities which were at the bottom of the pyramid. Sometimes there were six or seven tiers of holding companies.

As a consequence, a slight reduction in the earnings of the public utilities would have a devastating effect upon the ability of each holding company to pay its own debt and preferred stock requirements. This device thus resulted in complex corporate structures almost impossible for the average investor, or even sophisticated securities analysts, to fathom. It also resulted in an unfair distribution of voting power in that the holders of the common stock, with a relatively small investment, controlled all the other companies in the system.

Another evil was the holding by the holding company of public utilites in various separated parts of the country with no operating relationships between them. Thus some of the systems controlled public utilities as widely separated as the Pacific Coast and the East Coast; along with other utility companies in the middle west and southern states, and even in foreign countries. While these scattered holdings were attempted to be justified on the basis of diversification of risk and of the advantage of centralized management and purchasing, the studies indicated these were not meaningful advantages and Congress did not accept them.

A further evil was the presence in holding company systems of properties that had no relationship whatsoever with the operation of the public utility companies. Thus, in one system, there were water distribution companies, street railway companies, bus companies, ice companies, a ferry company, a hotel company, sewage companies, real estate companies and even a college.

Further, these empires were generally created by investment bankers who were interested in obtaining underwriter fees from the issuance of securities by each segment of the holding company system and not with an eye as to whether or not the companies were adequately capitalized or whether the companies could generate enough earnings to satisfy their fixed charges.

THE STRUCTURE OF THE ACT

The Act is basically concerned with only certain kinds of public utilities: (1) electric utility companies, and (2) gas utility companies. An "electric utility company" is defined as "any company which owns or operates facilities used for the generation, transmission, or distribution of electric energy for sale" (Sec. 2(a)(3)). A "gas utility company" is defined as "any company which owns or operates facilities used for the distribution at retail * * * of natural or manufactured gas for heat, lights, or power" (Sec. 2(a)(4)). Thus, a natural gas pipeline company is not a gas utility company.

If a company owns or holds 10% or more of the voting securities of a public-utility company, it is a holding company (Sec. 2(a)(7)), and any company 10% or more of whose voting securities are owned or held by a holding company is a "subsidiary company" of such holding company (Sec. 2(a)(8)).

Section 3 relates to the granting of exemptions to certain kinds of holding companies; section 4 makes it unlawful, unless it registers as a holding company pursuant to Section 5, to, among other things, for it or any subsidiary thereof, to transmit electric energy or distribute gas in interstate commerce, or to offer or sell any security by means of the mails or any instrumentality of interstate commerce.

Sections 6 and 7 concern the issue and sale of securities for any holding company or subsidiary company thereof. A company which desires to issue or sell any security must file a declaration with the Commission for such issue and sale and, before it may sell such security, the Commission must enter an order permitting the declaration to become effective. Section 7 sets forth the standards which must be satisfied before the Commission may permit the declaration to become effective. Among these standards is section 7(d) which requires the declaration to be denied if the security is not reasonably adapted to (a) the security structure of the declarant and other companies in the same holding company system; and (b) the earning power of the declarant.

Section 6(b) requires the Commission to permit, subject to terms and conditions, the declaration of a public-utility company to become effective if the State commission where such company is organized and doing business expressly authorizes the issuance and sale. Thus, while it is recognized that a State public utility commission has appropriate jurisdiction with respect to securities issued by local public utilities, it is also recognized that a State Commission has no jurisdiction as to holding companies. Only the S.E.C. has such jurisdiction. Thus, since at least three of the present gas utility holding company systems finance their operations solely at the holding company level, and no public utility company subsidiary issues and sells securities, no State commission has any jurisdiction over such issuances and sales.

Under Section 7(f) the Commission may impose terms and conditions to the issue and sale of the security. Under this section, and the correlative Section 6(b) (which concerns securities of public-utility companies authorized by a State public utility commissioner), the Commission in 1956 adopted minimum standards required for the protection of investors, to be included in first mortgage bond indentures and preferred stock charters.

Section 11, particularly Section 11(b) has been said to be the "heart of the Act." Under paragraph (1) the Commission has the duty to require each registered holding company system to take appropriate action to limit the operations of the holding company system to a single "integrated public-utility system" and to such other businesses as are reasonably incidental to the operations of such system; and to such additional integrated systems as satisfy certain standards. The term "integrated public-utility system" is defined in Section 2(a)(29)—one for electric utility companies and one for gas utility companies. Thus, a gas system and an electric system are two separate systems. They cannot, together, be a single integrated system.

Under paragraph (2) of Section 11(b), the Commission has the duty to require each registered holding company, and each subsidiary company thereof, to take appropriate action to (a) ensure that the corporate structure, or continued existence of any company in the system, does not complicate the structure, or unfairly or inequitably distribute voting power among security holders of such system; and (b) limit the number of holding companies in any system so that there can be only two holding companies above any public utility company in the system—the so-called "great grandfather provision."

The remainder of Section 11 deals primarily with the enforcement of orders of the Commission under Section 11(b), or plans submitted by companies to comply with the provisions of Section 11(b) and proxies for approval of such plans.

Closely related to Section 11(b) are sections 9 and 10 of the Act. Generally speaking, under section 9, no registered holding company or subsidiary thereof may acquire any securities or utility assets or any other interest in any business unless approval is first obtained from the Commission. Section 10 sets forth the standards for approval.

Section 10(b) requires that the Commission approve such acquisition unless (1) it will tend toward interlocking relations or improper concentration of control of public-utility companies, (2) the consideration to be paid is not reasonable, or (3) it will unduly complicate the capital structure of the holding company system or its proper functioning.

Section 10(c) provides the Commission shall not approve any acquisition (1) which the Commission finds is detrimental to the carrying out of the provision of Section 11, or (2) unless the Commission finds it will serve the public interest by tending towards the economical and efficient development of an integrated public utility system.

Thus, section 9 and 10 act as measures to prevent the recreation of the situations which are eliminated by the enforcement of Section 11.

Section 12 deals with intercompany loans; indemnification of, or lending of credit, by one company to another; the payment of improper dividends, the sale of outstanding securities and utility assets, proxies, intrasystem transactions. In particular, section 12(h) makes it unlawful for any registered holding company or subsidiary to make political contributions.

Section 13 deals with service, sales and construction contracts. Section 13(a) prohibits a registered holding company to perform such services for any other company in its system. Section 13(b) prohibits any mutual service company or subsidiary service company in a holding company system to perform such services for any other company in the same system except in accordance with such terms as the Commission shall prescribe to assure that such services are performed at cost fairly allocated among such companies.

Section 14 deals with reports to the Commission. Section 15 deals with accounts and records. Section 16 makes it unlawful to file a false or misleading statement with the Commission.

Section 17(a) deals with reports to the Commission by officers and directors of companies in registered holding company systems. Section 17(b) is the counterpart of Section 16(b) of the Securities Exchange Act of 1934. In particular, Section 17(c) prohibits any representative of any bank, trust company, investment banker or banking association from being an officer or director of any registered holding company or subsidiary thereof. This is a prophylactic provision to prohibit the determination of the financial activities of companies in registered holding companies to be made by persons personally interested in obtaining the contracts for such activities. Holding company systems and utility companies generally issue and sell securities probably more often than other industries. This section assures that decisions as to what and when securities are to be sold will be determined by persons having allegiance solely to the needs of the companies.

The remainder of the Act deals with administrative and court matters.

It can thus be seen that the Act is regulatory in nature. It prohibits certain kinds of transactions and requires Commission approval of a variety of activities. The Commission is required to make financial and economic decisions. This is unlike the Securities Act of 1933 which relates solely to disclosure in the sale of securities to the public; and unlike the Securities Exchange Act of 1934 which deals with reports required to be filed with the Commission, prohibits manipulation and fraud in the sale of securities, the full and fair presentation of financial statements by publicly held companies, information required to be disclosed in take-over efforts, disclosure of facts in proxy statements, and, of course, oversight of self regulatory associations, the trading markets, clearing agencies and transfer agents.

Under this Act, the Commission is not involved in the setting of rates. At the local level, the State public utility commissions set the rates; and the rates for the electricity carried from one state to another, and the rates for the transportation of natural gas across State lines, are determined by the Federal Energy Regulatory Commission.

As indicated, the State regulatory commissions have no jurisdiction over the activities of a holding company. This is particularly true where the holding company is incorporated in a State in which none of its subsidiary public utilities operate—there is no way, for instance, for the State in which the subsidiary utility operates to obtain the books and records of the holding company.

Similarly, as to service companies. If the service company is incorporated in a State in which none of the public utility companies operate, there is no way whereby those State commissions can examine the books and records of the service company. And, if the service company is organized by individuals, say the president and other officers of the holding company, makes no public offering of its securities, its financial statements would not have to be filed with the SEC under either the Securities Act or the Securities Exchange Act.

In conclusion, I believe the Public Utility Holding Company Act has served and continues to serve as an important bastion in the protection of investors and consumers. It must be remembered that the electric and gas utility industry is possibly the basic industry of the country—without it, hardly any, if any, other industry could operate.

Mr. **Freedman**. I shudder to think, Senator, if all the generating stations in this country were closed down for 1 day this country would be at a standstill. I'm sure the Senator remembers the two blackouts in New York City.

Senator D'AMATO. Mr. Freedman, you don't really mean to suggest that without this act that we're going to have blackouts?

Mr. FREEDMAN. No.

Senator D'AMATO. Nor should we attribute the blackout in New York City to the fact that we do have the act?

Mr. FREEDMAN. Maybe the blackouts occurred because the act did not apply to Con Edison. You can argue that, too. As a matter of fact, it might have occurred because there was something wrong with the generating stations and the transmission lines.

Senator D'AMATO. And the Commission would then become involved in seeing to it that the grid system was such that that would not take place and that one generator that went down——

Mr. FREEDMAN. No, I'm not saying that at all.

Senator D'AMATO. I think sometimes in an attempt to argue a position we may reach a little bit. Your suggestion that the act is responsible for the lack of the power blackouts is a difficult one for me to support.

Mr. FREEDMAN. I'm not saying that if this act was applicable to Con Ed there would be no blackouts. I am saying that this industry is basic to virtually every other industry.

In your kind invitation to me, Senator, you asked what accomplishments were affected by the act.

ADMINISTRATION OF THE ACT

The administration of the act by the SEC has resulted in the elimination from holding company systems of companies and properties that are not part of an integrated public utility system and properties that are not functionally related to such a system. As a consequence, there are now some 13 holding company systems, of which 9 are electric systems and 4 are gas systems. These systems are located each in a single area or region and are operated as a coordinated system.

The administration of the act has benefited the utility industry in that the companies that have emerged from the systems are independent and properly capitalized and their managements can act solely in the interest of the investors in that company and the company's consumers.

Investors can now analyze the financial operations of the separated companies, as well as that of the remaining registered holding company systems, much easier since their capital structures are more simplified and less complex.

Further, control of utility and holding companies is now vested in the holders of the common stock of such companies which do not constitute a relatively small investment.

The sale to the public of securities by companies in the holding company systems is now normally accomplished by competitive bidding, resulting in the cheapest cost of money to the companies with the attendant benefits to the consumers.

Incidentally, Senator, I don't see how the employment of competitive bidding impedes the sale of securities by any company and any registered holding company. They have to file a registration statement anyway and when they file the application or declaration under the Holding Company Act, the two go in tandem and the Commission has always met any target date that has been fixed by the companies who want to issue the securities so that the registration in the 1933 act and the order under the 1935 act go out together and there is no lag so far as underwriters are concerned because if there's a competitive bid on one day and if it's accepted by the company the securities are sold the next day, the same as any other normal issue of securities not subject to competitive bidding.

Further, the minimum standards required in first mortgage indentures and preferred stock provisions protect existing security holders and consumers from overcapitalization of the operating companies. These standards have also been adopted by companies not in holding company systems as a result of the recognition by their managements of the beneficial effects of such provision.

The requirement that construction, management, and service contracts by subsidiary and mutual service companies be performed at cost assures that such contracts are not unfairly expensive and their costs can be fairly allocated among the operating companies in the system.

As indicated, the Commission does not fix rates. However, the integration of the holding company systems and the simplification of the corporate structures of such systems, and the requirement that construction and service arrangements be performed at cost makes it easier for the State commissions to fix rates. Also, the activities of the Commission under the act do not conflict, but are in harmony with, the activities of the Federal Energy Regulatory Commission and the Nuclear Regulatory Commission.

Senator, I should like to finish by reminding the Senator of the benefits of this act upon the company in the area in which the Senator resides, Long Island Lighting Co. A little history which will take me about 2 minutes.

In 1936, Long Island Lighting Co. had three public utility companies. My recollection is Queens Borough Gas & Electric, Nassau & Suffolk Lighting Co. and King's County Lighting. The latter was solely a gas company. The other three were a combination gas and electric company. In 1936, Long Island Lighting obtained an exemption under section 3(a)(1) of the act since it and all of its operating subsidiaries were incorporated in New York and operated solely in New York.

Shortly after the exemption order was entered, disaster hit the company. It was ordered by the New York Public Service Commission to increase its reserve for depreciation which was woefully deficient. It was required to change its accounts to original costs and as a result of that, the Long Island Lighting Co. was unable to pay dividends on its preferred stock and then, of course, not on its common stock.

That lasted from about 1937 to 1944. To the extent that the company had to issue securities, it could not issue preferred stock, not with those arrears, or common stock. Or couldn't sell its bonds to the public since the bonds were not of public quality. They did sell them to the Metropolitan Life Insurance Co. It so happened that one of the directors of Long Island Lighting Co., was an important figure in Metropolitan Life Insurance, fortunately for the company—that is, Long Island Lighting Co.

Well, in 1944, the SEC commenced a proceeding to revoke the exemption because, under the statute, the circumstances had changed. At the time the order was entered, there were arrearages on the preferred stock of itself and there were arrearages on the preferred stocks of each of the three operating subsidiary companies. At first, the company opposed the revocation of the exemption, but after discussion with members of the staff, the company realized that it would be much better if it did not oppose the revocation of the exemption. The company became registered and filed a plan under section 11(e) of the act. As a result, the three companies were merged. All of the preferred stocks of each of the three companies were converted into common stock of the merged company. So as a result, the merged company's capital structure consisted of bonds and common stock.

The company could then sell new common stock and with the explosion right after the war of the population of Long Island, the company could finance all its requirements and so forth and so on. This could not have been done under any other act and certainly not under the State public service commission authority.

Thank you, Senator.

Senator D'AMATO. Mr. Freedman, thank you very much for your very comprehensive review of the act and its provisions.

Mr. Benore.

STATEMENT OF CHARLES BENORE, FIRST VICE PRESIDENT, PAINE, WEBBER, MITCHELL & HUTCHINS, INC., NEW YORK

Mr. BENORE. Good morning.

I'm pleased to be here this morning to express my views about the financial integrity problem of the electric power industry and to do whatever I can to foster constructive change to help resusitate the industry's poor financial condition.

Basically, this is an industry that has incurred a lot of problems because it's changed from a decreasing to an increasing cost industry. As this has occurred, managements of the industry have had to seek rate relief because they were unable to solve all of the industry's problems through cost reduction.

DECLINING FINANCIAL INTEGRITY

The response by regulation to rate relief from my perspective and that of investors generally has been inadequate. Primarily because of inadequate rate relief, the industry's financial integrity has declined to a very low level. There have been many downgradings in the quality ratings of the industry's bonds. Because of this and rising interest rates, the cost of capital has increased very dramatically.

I find it a bit alarming that in 1981 more than half of this industry's bonds had a term of 10 years or less. Effectively, this means that many powerplants that are expected to be in use for a period of about 30 years are financed only temporarily, and those companies will have to come back to the market time and time again to provide for permanent financing of this facility which raises risk to both investors and customers.

Unfortunately, it's also become increasingly difficult to raise common stock equity. In 1980 after serious problems in 1974 and 1975, this industry came to market and in 3 of those 12 months went away with less than 75 percent of what they sought at the beginning of each of those months.

The basic problem is that investors have been unable to make money in electric utility common stocks. The stocks have risen in only 5 of the last 16 years, based on the average price of one year to the next, and today they're trading at about 50 cents on the dollar the investor invested in 1965, and more alarming, about 20 cents on the dollar based on 1965 constant purchasing price dollars.

Another problem that's a companion to the declining prices of this group is confiscation of investor ownership and return through the sale of common stock below book value. This is something that is generally not understood and its implications I think are extremely important.

In an illustration, assume if you will, that a company that sold common stock had a book value or an investment value per common share of $10 and after selling below book value had a book value of only $9.33. This is effectively like taking $10 out of your pocket and giving you $9 back and 33 cents in change.

Senator D'Amato. Mr. Benore, if I might, I would like to ask a question before you get too far away from one point that you made. You noted the depressed state of the utility industry and of utility stock; but doesn't that equally describe both companies that are under the purview of the act, and those that are not?

Mr. Benore. Yes, sir; it does.

Senator D'Amato. I just think so the record is fair, we want some balance. Even though I have sponsored some of the legislation, I think it's only fair that we not attribute all of the problems that the industry faces, in terms of its depressed stock and the inability to raise sufficient capital, to the act. That's just like saying the power outages in New York took place as a result of ConEd's not being regulated by the act.

Mr. Benore. I think your point is an excellent one and is very well taken. I'm trying here to build background and from that to talk about specific problems that the act is creating in terms of capital availability and its cost to those companies that are regulated by the act.

The essence of the problems is that the act is contributing to the industry's problems by reducing financing and diversification flexibility.

Other than changes in the act, lower inflation would help. I think management communications with its customers to help them better understand utility economics would also help. Certainly better regulation would help as well. But it's uncertain that these primary solutions to the industry's problems will be able to entirely solve them and, therefore, I recommend that other constructive alternatives to increase the industry's financial integrity and capital availability be studied very seriously.

FINANCIAL FLEXIBILITY

One of these, I believe, is to improve the flexibility of companies subject to the Public Utility Holding Company Act of 1935 with respect to their ability to finance on a timely basis and to diversify into nonutility businesses.

The problem in terms of financial flexibility is that these companies are limited basically to three types of securities. If a company's financial integrity is so low that its indenture or charter blocks it from the issuance of securities, the company cannot turn to a debenture or preference stock, for example, to bail it out of its particular financial problems at that moment.

Another financing problem is that there's generally a 60 day waiting period from the time the company proposes to issue securities before it can actually issue them. Many times, good windows in the market are only open for a week or a month. For many companies subject to the act, those windows are opportunities for capital availability and perhaps capital at lower cost that are given up or passed.

Furthermore, with respect to competitive bidding, there are times—and I'm sure that it's not all the time—when a negotiated offering is best, and it is foreclosed by the act unless permission by the SEC is given after a lengthy period of time of consideration.

Another aspect of flexibility that would help the electric power industry is diversification. Diversification, if successful, beneficial to investors and material enough to impact on the company's financial integrity, would help the industry to improve its investor following and, in turn, its capital availability and quite probably lower the cost of capital as well. This, in turn, I think would be beneficial to customers as well because of the improved prospects of adequate and reliable electric service in the future. Thank you.

[Complete statement follows:]

FINANCIAL STATUS OF THE ELECTRIC POWER INDUSTRY

Charles A. Benore
Paine Webber Mitchell Hutchins Inc.

I am pleased to be here this morning to express my views on the financial integrity of the electric power industry and how constructive changes in the Public Utility Holding Act of 1935 could help the industry to raise capital and fulfill its responsibilities to our country and the industry's customers.

The electric power industry, after the mid 1960's, changed from a decreasing to an increasing cost industry—that is its revenues did not rise in recent years as rapidly as costs. Consequently, it has been necessary for managements in the industry to seek rate relief in order to maintain a satisfactory financial integrity level and, in turn, the ability to continue to provide adequate electric power service.

The efforts of managements to maintain an acceptable financial integrity level have generally been unsuccessful. In part, this result reflects, a lack of sufficient managerial aggressiveness in seeking rate relief, until recently rising inflation and the associated challenge of trying to keep up with a cost target moving at an accelerating rate of speed; and an inadequate response by regulation. The principal problem, in my judgment, has been an inadequate regulatory response.

Because of inadequate amounts of rate relief, the industry's financial integrity has substantially declined. In turn, this has caused investors to reevaluate the investment prospects of the industry. As this reevaluation occurred, the industry began to encounter problems in attracting capital especially in 1974 and 1975, and again in 1980 and 1981.

There has been a rash of downgradings in the quality ratings on the industry's bonds as financial integrity declined. For the ten years, 1971 1980, there were 114 downgradings by Moody's of public utilities compared to only 46 upgradings, as shown on page 1 of the Exhibit. Because of the declining quality of debt securities of public utilities and rising inflation, such capital has become much more expensive. Furthermore, it has become increasingly difficult for electric utilities to raise debt capital with the normal 30-year term. In 1981, for example, more than 1/2 of all bond financing by electric utilities had a term of ten years or less as is shown on page 2 of the

Exhibit. This effectively means that bond investors are no longer willing to finance electric power plants which generally have about a 30-year life with bonds of a similar life. Therefore, the financing of many plants now under construction by the industry is temporary in nature. Risk to customers, therefore, has increased because such plants will have to be financed several times over their useful lives.

It has also become increasingly more difficult to attract common stock equity capital. The simple reason is that investors have not been able to make money in electric utility common stocks as shown on Exhibit page 3. The S&P electric utilities, since 1965, have trended downward in price compared to a general upward trend in price for common stocks generally. In fact, electric utility common stocks are now trading at about one half of their 1965 market values, or 50¢ on the dollar, and about 20¢ on the dollar in dollars of constant 1965 purchasing power.

As electric utility prices declined, another problem developed. The common stocks of electric companies began to sell below book value. This means that when an electric utility company sells new common stock, as illustrated on Exhibit page 4, the stockholders' investment is diluted. As shown in the example, the book value representing the investors' ownership per common share falls from $10.00 to $9.33. This is like reaching into someone's wallet and withdrawing a $10 bill and giving back only nine dollars and thirty-three cents in change. Economic confiscation is something that investors naturally have an incentive to avoid.

A related malady is that investors are entitled to earn on their book value investment. As the book value declines, so do earnings on such an investment. This is also shown in the illustration on page 4 of the Exhibit. Earnings per share fall from $1.80 to $1.68. This is similar to cutting one's wage from something like $1.80 to $1.68 an hour. Again this is something that would discourage knowledgeable investors from buying such companies, especially if it occurs repeatedly over time as has been the case in this industry since 1973.

It is not surprising, therefore, that electric utility companies experienced difficulties in raising common stock equity in 1974 and 1975 and again in 1980. In 1980, there were three months when electric utilities came to the market for capital and went away with less than three quarters of the common stock equity sought. It is abundantly clear, therefore, that the electric power industry has become a financially weak industry which, in turn, has (1) increased the cost of capital to the industry, and (2) made it impossible for the industry to attract capital on a regular basis.

Given the indispensable nature of electric power supply to growth, improvement of living standards, and employment, it is clear that constructive actions are required to relieve the industry's financial problems.

The resolution of the industry's problems, in my judgment, depend upon constructive changes in three principal areas. The first of these is our efforts to reduce inflation. The Federal government can also help the capital attraction process of the electric power industry, if it so chooses, by eliminating the double taxation of dividends. Furthermore, the Federal Energy Regulatory Commission could serve as an example of more reasonable regulation. In this spirit, timely and adequate rate relief with returns to investors comparable to other companies of similar risk and of similar quality are necessary.

Second, management of the industry could become even more vigilant in cutting costs and must, in my judgment, undertake a more active role in communicating with its customers. Customers want to know why their bill is rising and what management is doing to keep the bill as low as possible. I believe it is the customers' right to have such information, and that generally, the management of the electric power industry has done an inadequate job in answering these justifiable customer questions.

Third, regulation should insure that the returns earned by electric companies would enable such companies to achieve a satisfactory level of integrity so that capital will be available to provide electric power service, and other desirable objectives such as the capital to convert oil capacity to coal in order to increase the country's energy self-sufficiency, or for pollution control and a cleaner environment.

It probably will be very difficult to reduce inflation sufficiently to relieve the industry's financial problems. It will be difficult for consumers to understand utility economics and be tolerant of an annual increase in rates of about 10% in the foreseeable future. Based on the empirical evidence, it will also be difficult to convince regulation that a financially healthy electric power industry is in the customer's best long-term interest.

Because of the uncertainty of resolving the industry's financial integrity problems through lower inflation, lower cost, better customer relations, and through regulation, other constructive ways to help restore the industry's financial integrity should be considered.

One such constructive alternative to increase the industry's financial integrity and capital availability is to improve the flexibility of the companies subject to the Public Utility Holding Company Act of 1935 with respect to their ability to finance on a timely basis and to diversify into non-utility businesses. Successful diversification could help to increase financial integrity and thereby increase capital availability as well. This desirable outcome requires that such diversification be (1) successful, (2) beneficial to investors in contrast to regulatory pass-through of the benefits to customers, and (3) material, or sufficiently large to have a meaningful impact on a company's financial integrity.

If these prerequisites are met, diversification would have the effect of benefiting investors through improved compensation for the use of their capital and customers, as well, through a greater assurance of capital availability and future electric power service.

Exhibit Page 1

UPGRADINGS AND DOWNGRADINGS BY MOODY'S OF BONDS OF UTILITY AND INDUSTRIAL FIRMS, 1971-1980

	Public Utilities		Industrials	
Year	Up	Down	Up	Down
1980	3	16	18	32
1979	11	8	11	27
1978	3	4	17	15
1977	6	5	14	26
1976	2	10	13	18
1975	7	16	32	19
1974	6	41	13	22
1973	5	3	14	19
1972	1	5	17	8
1971	2	6	10	14
Totals	46	114	159	200

Source: Moody's

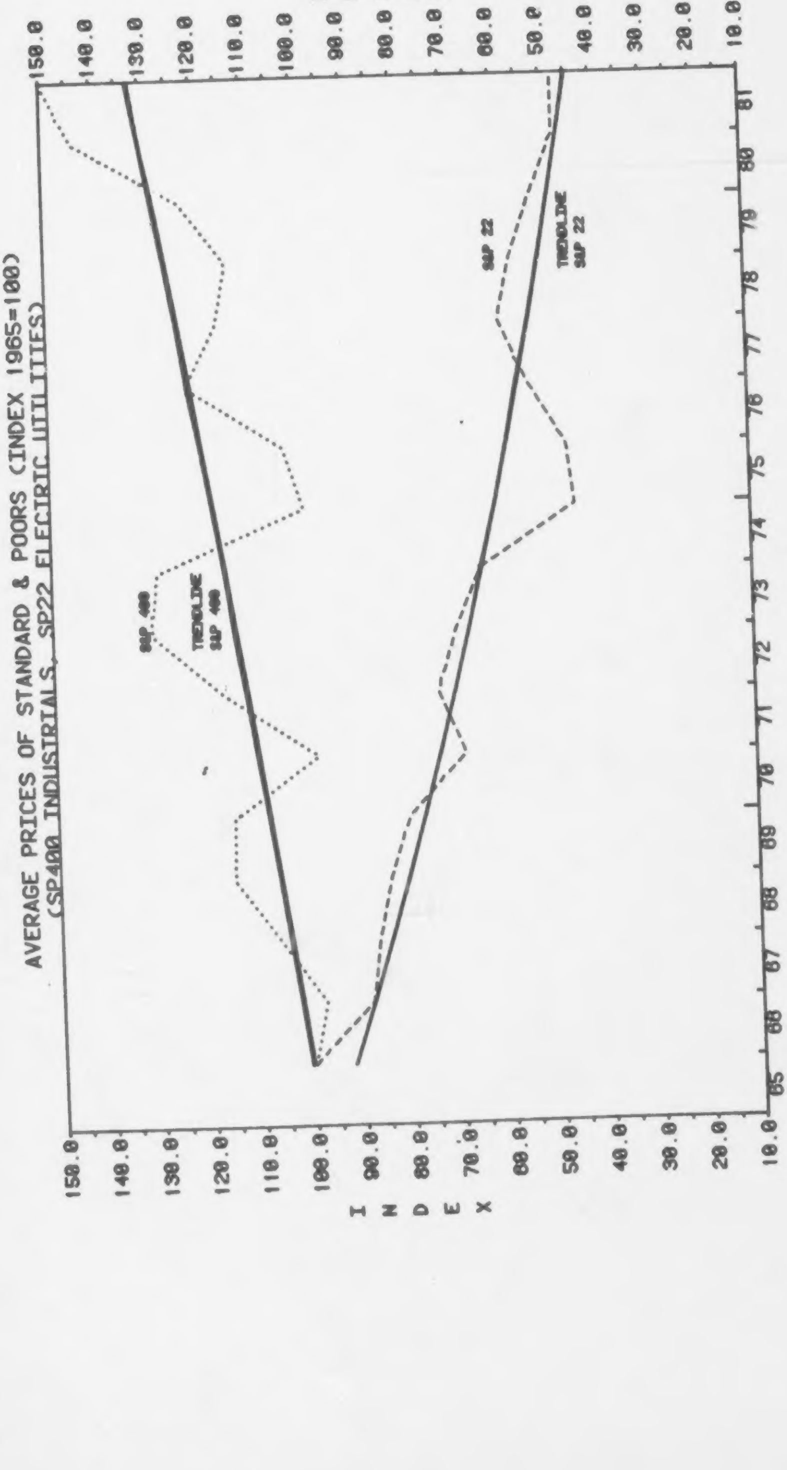
Exhibit Page 2

Bond Financing by Electric Utilities in 1981 by Term ($ Millions)

Line No.		All Ratings Over 10 Years	 10 Years and Under
1	December 1981	$ 490	$ 150
2	November	315	265
3	October	60	640
4	September	200	365
5	August	none	255
6	July	255	80
7	June	375	100
8	May	325	540
9	April	325	255
10	March	245	235
11	February	-	475
12	January	200	445
13	Totals	$2,790	$3,805

14 Source: Reis and Chandler

Exhibit Page 3



AVERAGE PRICES OF STANDARD & POORS (INDEX 1965=100)
(SP400 INDUSTRIALS, SP22 ELECTRIC UTILITIES)

EFFECT OF A DECLINING PRICE-TO-COMMON EQUITY BOOK VALUE PER SHARE RATIO ON EARNINGS PER SHARE, ASSUMING SALE OF NEW COMMON STOCK OF $200

	Base Period Data	Price-to-Book Value Level 1.3X	Price-to-Book Value Level 1.0X	Price-to-Book Value Level 0.7X
Common Shares Outstanding	100	115.4	120	128.6
Common Stockholders' Equity	$1,000.00	$1,200.00	$1,200.00	$1,200.00
Return on Equity	18%	18%	18%	18%
Net Income Available to Common Shareholders	$ 180.00	$ 216.00	$ 216.00	$ 216.00
Book Value	$ 10.00	$ 10.40	$ 10.00	$ 9.33
Common Stock Sale Price		$ 13.00	$ 10.00	$ 7.00
Earnings Per Share	$ 1.80	$ 1.87	$ 1.80	$ 1.68

DUTIES AND PROFESSIONAL QUALIFICATIONS

Q. Please state your current duties and responsibilities for the record.

A. I specialize in the analysis of utility securities at Paine Webber Mitchell Hutchins, Inc. My firm provides investment research services to institutional and individual investors. Our clients include most medium and large-sized financial institutions in the United States and many abroad as well, and individual investors through Paine, Webber, Jackson & Curtis, which is another subsidiary of Paine Webber, Inc.

Q. Are you familiar with the investment concerns of security investors?

A. Yes. Paine Webber Mitchell Hutchins is in daily touch with hundreds of portfolio managers, traders and security analysts from banks, corporations, insurance companies, mutual funds, and other financial institutions, and individual investors. This activity gives us a very current view of buyers and sellers of securities.

Q. Please summarize your education and business background.

A. I hold a Bachelor of Science degree in Commerce from Ohio University and a Master of Arts in Economics degree from Ohio State University. For the past 15 years, I have been a financial analyst and investment advisor in the field of public utilities, and have been employed successively by Duff and Phelps, F. I. DuPont, Salomon Brothers, and since April 1974, Paine Webber Mitchell Hutchins.

Q. Have you testified before other commissions or made presentations before professional groups?

A. Yes. I have presented testimony before 26 State Public Service Commissions and the District of Columbia. I have also submitted testimony to the Federal Power Commission and the Federal Energy Regulatory Commission on rate of return and on the subject of earning a cash return on construction work in progress, and have appeared before the Securities and Exchange Commission, the U. S. House of Representatives Subcommittee on Energy Conservation and Power on the subject of energy financing, and the U. S. House of Representatives Subcommittee of Science and Technology on "The Future of the Nation's Energy Utilities."

I have made numerous presentations before the financial community, such as the Cleveland Society of Security Analysts, the Rochester Society of Security Analysts, the Salt Lake City Society of Security Analysts, the Louisiana Bankers Association, the Pennsylvania Bankers Association, the National Association of Savings Banks, the Public Utility Club of Chicago, and television programs, Wall Street Perspective and Wall Street Week.

I have presented papers before an Executive Conference sponsored by Electrical World on "Increasing Internal Cash Generation—Investor Attitudes Toward AFC" (allowance for funds during construction); the Iowa State University Regulatory Conference on "Investor Appraisal of Return on Plant Under Construction," to the American Bar Association National Institute on "An Investor Perspective of Financial Integrity and Comparability;" to the NARUC Staff Subcommittee of Accounts on "Accounting Procedures and Standards Related to Capital Formation in the Electric Power Industry;" to the Edison Electric Institute Financial Conference on "Dividend Policy and Common Share Valuation of Electric Utilities" and "Closing the Gap Between Allowed and Realized Return on Common Stock Equity;" to the University of Florida Public Utility Research Center on "Financial Integrity and the Ability to Raise Capital;" to an Advanced Management Research, Utilities Financing Conference on the "Capital Attraction Potential of the Electric Power Industry," to the California Public Utilities Commission Symposium on "Energy Utilities - A Financial Status Report," and to Michigan State University Utility Conference on "The Financial Viability Prospects of the Electric Utility Industry."

I am also a speaker on rate of return for the Irving Trust "Public Utilities Financial Seminars," and a member of the Financial Accounting Standards Board task force on utility accounting, and a task force member of an Informal Task Force to the Energy Transition Team of the Reagan Administration on recommendations to restore the financial health of the electric power industry.

I have attended seminars sponsored by the Financial Analysts Federation including the Securities Analysis Seminar at Rockford College, the Investment Management Workshop at Harvard University, and the Investments Risk Analysis Seminar at the University of Virginia.

Q. What memberships in business, financial or scholastic societies do you have?

A. I am a member of the Financial Analysts Federation, New York Society of Security Analysts, and Wall Street Utility Group. I am a Chartered Financial Analyst and Financial Analyst Federation Fellow. I was also elected to Phi Kappa Phi and Beta Gamma Sigma honorary societies.

Senator D'AMATO. Thank you very much, Mr. Benore.

Let me ask Mr. Freedman, what features of the Holding Company Act as it operates today, both from the perspective of protecting the investor and the consumer, do you see as essential?

Mr. FREEDMAN. Well, I think, contrary to what the gentleman to my right says, that the protective provisions requiring indentures and preferred stock protects existing securities holders.

Senator D'AMATO. You think they're essential?

Mr. FREEDMAN. Yes, and so do managements of companies that were not subject to the act because they put them in.

Now when you say essential, the world won't fall apart if this act is repealed, just like if this act is repealed there will no longer be any blackouts.

Senator D'AMATO. We've got that established.

Mr. FREEDMAN. The only reason I mentioned the blackouts, Senator, was to indicate that as a result of that blackout——

Senator D'AMATO. More babies were born in New York 9 months after than in the history of the State for many years.

Mr. FREEDMAN. Senator, they were not born that day.

Senator D'AMATO. Nine months after I said, approximately, give 24 hours or 48 hours.

Mr. FREEDMAN. I think we've beaten the blackout to death. May I have the question again?

RETAIN CERTAIN PROVISIONS

Senator D'AMATO. Those provisions of the act which you feel are essential—obviously, you feel that the act is important—but those specific provisions that go to the essence of protecting both the consumer and the investor.

Mr. FREEDMAN. Well, I think the provision relating to the exclusion of investment bankers on the boards of the holding companies of public utility companies ought to be retained. I think that provision regarding service and construction contracts ought to be retained—maybe modified a little bit, but not the way some of these bills suggest. I think it's essential that there be some mechanism in place so that there will not be a re-creation of the evils that existed that required the act to be passed in 1935.

Senator D'AMATO. That's a shotgun answer, that one.

Mr. FREEDMAN. Well, section 9 and 10—of course, the trouble is, this act is so integrated, section by section, that it's necessary to retain a number of sections to get the point across. Thus section 11 requires that the companies not have a complicated structure. Section 9 is tied in with that, so that any proposed acquisition of securities will not have the effect of having a complicated structure which is denounced by section 11.

In another section maybe you can grant some additional exemptions under section 3(a), the exemptive section, although they're extremely broad now, and I forget what the number of exemptions that were granted—they went into a couple hundred.

Senator D'AMATO. Mr. Freedman, let me ask you one further question. Would you be in favor of allowing the utilities under the act to go into alternative sources of energy as has been suggested?

You've heard some of the testimony—or allowing other corporate entities to move into this area as well.

Mr. **Freedman**. Senator, under this bill, companies registered as holding companies can go into all kinds of alternative sources of energy.

Senator **D'Amato**. You're saying that the act does not prohibit utilities from engaging in these types of business activities—industrial development, alternative sources of energy, and so forth?

Mr. **Freedman**. I'm talking about alternative sources of energy. I don't know about industrial development. I don't know what that means. If you mean building a shopping center, then under this act, that is not permitted, but if you're talking about going into research for——

Senator **D'Amato**. Coal?

Mr. **Freedman**. Coal, they can do it. As a matter of fact, under this act, registered holding company systems own coal companies where, most of the coal is used for power in the generating stations of the system. Even a railroad was permitted to be retained because the railroad carried the coal from the coal mine to the generating station. That was retainable.

So this is not so narrow a provision. Now whether or not you want to allow companies in holding company systems to get into extraneous businesses that have nothing to do with the operation of the system is, I think, another matter. Congress, in 1935, thought it was wrong. If this act is repealed, there would be nothing to prohibit a holding company from building a casino in Atlantic City and going into the gaming business.

Senator **D'Amato**. I'm going to ask for a recess. We are in the midst of a vote, and I would say it would be about 10 minutes, as much time as it takes me to get down there and vote, and then we'll have more questions. So we'll have a 10-minute recess.

[Recess.]

Senator **D'Amato**. The subcommittee will come to order.

Mr. Benore, I'd like to ask you a few questions.

DIVERSIFICATION AS A DISTRACTION

Do you believe that permitting diversification would detract from the management and resources needed by the utilities to perform their primary function? That is a question that has often been raised. Could diversification lead to the diversion not only of managerial resources, but also of necessary capital into other businesses which are not related to the primary function of that utility, the production and distribution of energy to consumers in the most efficient manner possible?

Mr. **Benore**. At least initially and certainly in the conception phase, management time and creativity and expertise would be diverted to the nonutility businesses, but I don't think it's necessarily permanent in nature. Those who are better fitted to run a nonutility business may be transferred to that particular subsidiary and those that would do better in the utility business might be moved up if there are qualified people available within the utility company, or they may be hired from the outside. Management could also be hired to operate the nonutility business.

I think the important point here to recognize is that this doesn't have to be permanent. Quite probably, it would be temporary, and there wouldn't be a permanent management drain or a diversion of their talents to the nonutility segment of the business. Therefore, I don't think that it would have a permanent negative impact.

With respect to the diversion of capital into other areas, if it was set up as a holding company, the nonutility subsidiary would sell its own debt and preferred and the holding company would raise common stock capital. The essence of the ability of the holding company to raise common stock capital is that it be able to attract such capital from investors. If this is a successful diversification effort in terms of improving financial integrity, I think indeed it would help to attract and not detract from the ability of such a company to raise common equity capital.

Senator D'AMATO. How has the financial performance of nondiversified utilities compared with that of diversified utilities?

Mr. BENORE. I have not done a study of this. I can only therefore give you my impressions based on what I've observed in 16 years of being a utility analyst.

I have found generally that the diversification efforts of electric power companies have, on balance, been successful. I have also found in the electric power companies that I analyze as an analyst that I generally feel more comfortable with those companies because of the profit opportunities and the related enhancement to financial integrity that stem from these diversified operations.

I have generally found them to be a plus and, as a result, to make that company more attractive than it would otherwise be. I reason that if this historical record can be continued into the future, that diversification is a constructive consideration for improving the industry's financial integrity and its capital attraction ability.

Senator D'AMATO. Mr. Freedman, do you see any meaningful differences between electric and gas utilities in terms of the need for regulation under the act? Is there any distinction between the two that would call for different treatment under the act?

Mr. FREEDMAN. Well, under the act, of course, pipeline companies are not public utilities, only retail gas companies, and their problems with respect to finance are the same as electric companies. There are a great many combination companies. This act was supposed to, in effect, eliminate them except in extreme circumstances. But the way the act was administered, we felt it more important to eliminate, what we call combination companies, from holding company systems, than to first require the separation of the gas properties from the electric properties. That's why Long Island Co. now is a combination company.

Senator D'AMATO. You don't see any great difference?

Mr. FREEDMAN. No. Incidentally, may I comment on something Mr. Benore said about the so-called independent companies not in registered holding company systems that are in diversified operations seem to fare better from a financial viewpoint than companies subject to the Holding Company Act.

Senator D'AMATO. He didn't quite say that, but I'd like to hear what you have to say on the subject.

Mr. **Freedman**. Well, if you're going to come to any conclusion you have to make a big study. You have to take all these companies, all these companies that are exempt. What did they get into? Now when he talks about diversification, if what he's talking about is a coal mining company the output of which is used by the electric generating system, that's not a diversified operation, in my opinion. So you've got to be careful to see what these companies have done.

Senator D'**Amato**. As you have stated, the development of alternative sources of energy is perfectly consistent with the act and can be undertaken by the companies without any additional problems.

Mr. **Freedman**. I think so, yes. You've got to study each one, of course. Each factual situation may be different.

Senator D'**Amato**. We'll pose the question of what the problems may be to the next panel who represent some of the utility companies affected by the act.

I'd like to thank this panel; Mr. Freedman, for your thoughtful presentation of the circumstances which gave rise to the act, and, Mr. Benore, for your testimony regarding what might be done to improve the act. Thank you very much.

I call the second panel: Floyd Lewis, chairman of the board of Middle South Utilities, Inc.; Eugene Luntey, president and chief executive officer, Brooklyn-Union Gas Co., on behalf of American Gas Association; Alan Richardson, legislative director and counsel, American Public Power Association; and Edwin Rothschild, Energy Action Project, Washington, D. C.

We are now in the process of another vote. When three more of those buzzers go off I have 5 minutes and I'll have to take leave to go down and vote again.

Mr. Lewis.

STATEMENT OF FLOYD W. LEWIS, CHAIRMAN OF THE BOARD, MIDDLE SOUTH UTILITIES, INC., ON BEHALF OF EDISON ELECTRIC INSTITUTE

Mr. **Lewis**. Thank you, Mr. Chairman. I appreciate the opportunity to appear before you today to speak in support of S. 1977 by Senator Johnston, which would repeal the Holding Company Act.

I am Floyd Lewis, chairman and president of Middle South Utilities, Inc., which is one of the 12 holding company systems still fully regulated under the 1935 act.

Senator D'**Amato**. And I think for the record I should disclose that my wife is a stockholder of your company and owns, by way of inheritance, one share. I think we get 46 cents a quarter or something. I know there's a little check that comes.

Mr. **Lewis**. That's per quarter.

Senator D'**Amato**. It used to be 32 cents. I watch it very carefully. It costs you poor guys a lot of money to mail to this one shareholder.

Mr. **Lewis**. We need to find a way to increase her holding.

Senator D'**Amato**. Will you give her a stock option plan to purchase with the dividends?

Mr. LEWIS. Yes, we do have that, but I don't think that would be very productive in her case.

I also am here in behalf of the Edison Electric Institute, (EEI), which is the association of investor-owned electric utility companies. Its membership is composed of substantially all of the investor-owned electric utility companies in the country and they provide about 77 percent of the Nation's electric service.

Senator D'AMATO. I'm going to have to go down and vote. Unfortunately, Senator Brady is there voting and I'm going to ask him if he comes up in the interim to continue this hearing. So in the absence of Senator Brady or myself, I'd ask that we take a brief recess.

[Recess.]

Senator D'AMATO. Mr. Lewis, will you proceed.

Mr. LEWIS. Thank you, Mr. Chairman.

Right off the bat, I would say that we totally agree with the position of the Securities and Exchange Commission as expressed in Chairman Shad's letter to Senator D'Amato. There are a couple statements in there that I would like to refer to and that is that "the Commission's task of reorganizing the Nation's gas and electric utility holding company systems was completed 20 years ago." Another one, "If the 1935 act is repealed, all publicly-owned utility holding company systems will, of course, continue to be subject to the financial disclosure requirements and other provisions of the Federal securities laws."

And this one: "unlike the other statutes it administers, the 1935 act involves the Commission very deeply in the substance of fundamental management decisions."

There are presently only 12 holding companies that fall within the registration provision of the act. Nine of these are electric systems and three are gas systems. In terms of 1981 gross revenue, the nine electric companies represent about 20 percent of the investor-owned electric utility industry; and the three gas systems represent about 8 percent of the gas utility industry.

Speaking for the electric utilities of the country and specifically for these nine registered companies, our basic plea is to be put on a basis comparable to the other 80 percent of the electric utility industry.

EXEMPT STATUS

Approximately 80 holding companies are in the exempt status under the act. However, it's most important to recognize that these exemptions are discretionary. Holding companies may enjoy the freedom offered by these exemptions only so long as the SEC finds them appropriate.

In order to understand why the legislation was enacted we ought to examine the environment at the time it was enacted, and I certainly wouldn't want to take away anything from the pride that Mr. Freedman has in terms of what was done to correct the bad situation that existed. In the 1920s, the utility industry was undergoing a period of major growth. Since the SEC was not established until 1933, the securities of utilities and of all other industries were not subject to regulation. The boom mentality which pervaded the entire decade and the lack of effective securities regulation created a classic speculative bubble.

Utility rates and many other practices that are regulated today were also not subject to regulation then. State regulatory agencies at the time were few and poorly staffed. As late as 1935, there were only 22 states that regulated electric utility rates.

Furthermore, court decisions strictly limited State regulatory authority and there was no Federal commission such as the FERC that regulated utilities interstate rates. Moreover, the courts were particularly liberal in allowing utilities to set a value on their own property for purposes of ratemaking, sales, security issuance. With little regulation on either the State or Federal level, an unsophisticated investing public and a rapidly expanding industry, the scene was ripe for security violations.

The main use and abuse of the holding company form of organization that precipitated the 1935 act was the use of a small controlling interest as a means of controlling large amounts of capital through what is known as "pyramiding." When the giant Insull utility trust collapsed in 1929, there were more than 10 layers between the operating companies and the controlling group at the top. Using these methods, individuals and groups were able to control large collections of capital with only small amounts of their own actual investment.

I would submit that the circumstances that exist today are totally different than those that led up to the existence and the passage of the Holding Company Act. In the area of accounting, for instance, the SEC requires utilities to utilize specific accounting standards and specific forms and contents of financial statements included in SEC filings.

It has the authority to do this under the 1935 act but it doesn't use it there. It actually requires this under the 1933 and 1934 act, acts that we're not suggesting be changed. Moreover, uniform accounting standards are required by the Federal Energy Regulatory Commission for its regulation of the industry. Most State commissions have adopted standard systems of accounts, many of them adopting the FERC standard of accounts; and furthermore, the sophisticated accounting industry has led to the adoption of uniform accounting standards for all industries and businesses.

Another provision that the Congress included in the 1935 act provides that transactions among affiliates in a holding company system come under SEC regulation. However, both the FERC and State public utility commissions now have the authority to scrutinize such affiliate transactions.

Any claim that State public utility commissions cannot control affiliate transactions is, we believe, of questionable validity. If the reasonableness of a particular transaction is not shown, they can disallow that expenditure from the computation of allowed rates, thus striking at the very heart of a utility's operations. various of the utility regulatory commissions of the States in which the Middle South System companies operate—those being Arkansas, Louisiana, Mississippi and Missouri—have reviewed the financial records of our service company and our fuels subsidiary to examine the basis for charges between companies in our system. We believe it's instructive to note that they have performed their own audits of these affiliates and have not relied upon the SEC.

The abuses that arose during the 1920s that resulted in the passage of the 1935 act represented a unique period of economic history that could not be repeated today for a number of reasons, not the least of which is effective State and Federal regulation of the utility industry which has developed over the last 47 years. The amount of intense scrutiny that utility companies receive today from sources other than the SEC Holding Company Act staff is more than sufficient. The 1935 act is a prime example of legislation which has served its purpose and I wouldn't argue that it served it well back up through 20 years ago, and because of changed circumstances over the 47 years since its enactment, is no longer needed and should be repealed.

Now some might argue that since essentially all of the requirements of the Holding Company Act are embodied in other legislation, there's just no reason to repeal the act. They would say that precisely because the act is currently duplicative, repeal of the act would be of small benefit.

I would take issue with those arguments on both philosophical and practical grounds. We believe that any existing laws and regulations when they come under scrutiny ought to have to be justified. In a period when our troubled economy is burdened with heavy regulatory costs which contribute to the weakness of our industrial capacity and when Congressmen and Senators are forced to make extremely tough, unpleasant choices among programs which serve real needs, we believe that the burden of proof must be borne by those who want to keep regulation in place. They should be required to present substantial evidence that the laws and/or regulations in question are still needed, not just that they don't do much harm.

We submit that since attainment of its basic objectives, the 1935 Holding Company Act has actually done harm. The 1935 act which was set up to protect investors and ratepayers has often produced results to their detriment.

The requirements of the 1935 act are wasteful. The estimated expenses incurred by the Middle South System associated with the various Holding Company Act filings for the 1-year period June 30, 1980 through June 30, 1981 total $465,000. Other registered holding companies doubtless incur comparable costs, and these are only the direct costs to utilities and do not include the cost of lost opportunities due to regulatory redtape.

MANAGEMENT FLEXIBILITY

SEC approval is required for numerous regular transactions ranging from sale and leaseback of oil storage tanks to the establishment of a bank line of credit. The provisions and policies of the Holding Company Act have impaired the financing activities and operations of companies subject to the act and, as a result, have adversely affected management flexibility and the competitive position of such companies in relation to nonholding company utilities. Generally, in addition to the time required for preparation of a filing, there is at least a 60-day waiting period between initial filing and receipt of an order under the 1935 act permitting the transaction. Because of these long delays, registered holding companies and their subsidiaries are unable to take advantage of "windows" in the financial markets and many transactions with "short fuses" never get off the ground, thus preventing management from further reducing the cost of capital. Other companies with which we must compete in the financial markets do not have this extra burden.

We can see no circumstances where there is real need for the filing of a Registration Statement under the 1933 act and also the presently required filing under the 1935 act. Many other filings are duplicative also. Companies subject to the 1935 act are required to file an annual report, form U5-S, with the SEC. In addition, the same companies are required to file an annual report, form 10-K, with the SEC under the 1934 act. The reports include duplicative information. This puts an unnecessary burden on the companies to render the same information twice to the SEC and as a result increases costs to the companies and their customers.

And I brought with me just as an illustration one financing transaction, $90 million of first mortgage bonds issued last November by the Arkansas Power & Light Co., one of our operating companies—this is a filing with the Arkansas Public Service Commission who looked at this issue as to whether it made sense from the standpoint of the local regulated utility.

This is a filing under the 1933 act [indicating], and I would say to you that this is the filing of the 1935 act [indicating], and it is totally surplus as far as I'm concerned.

In the area of financing, the Holding Company Act dictates numerous requirements which, singularly and in the aggregate, have limited the ability of the registered companies to tailor the terms of their securities to reflect the frequent and sudden changes occurring in the volatile securities markets.

Under rule 50 of the Holding Company Act, it precludes the issuance and sale of securities except pursuant to competitive bidding. This requires publication of a formal invitation for bids and the receipt of competitive proposals for the purchase of securities at least 6 days after publication. If you can negotiate you have much more flexibility; you do not have to set a certain time for taking the bids in the future.

The Statement of Policy regarding first mortgage bonds, which Mr. Freedman referred to, and said other companies had implemented some of those same requirements; I would say to you that it's tended to make those companies that are regulated under the Holding Company Act less competitive in the marketplace, resulting in higher interest costs to the borrowing company and, therefore, higher costs to ratepayers. These restrictions generally are not desired by investors. In fact, some restrictions required under the act may result in higher interest demands by investors.

For example, under the Holding Company Act, a company must comply with redemption restrictions in an era when a creative response to market conditions would dictate other redemption provisions. Other utilities, those not under the act, have been able to negotiate the circumstances under which a particular series of bonds would be redeemable. Companies subject to the act are limited to a restriction on optional redemption prices which has not satisfied many investors in this volatile market. Potential investors appear to be greatly concerned about the possibility that their bonds might be redeemed before they become due. Our inability to respond to these concerns is costly.

Companies subject to the Holding Company Act are further burdened by the Statement of Policy's artificial limit on earnings that may be counted in determining whether a company may issue first mortgage bonds. For example, under the act, no more than 10 percent of the earnings used to meet the issuance test generally required on utility bonds can come from a source other than utility revenues. The industry norm allows this figure to be 15 percent. Yet, under the act, companies are forced to reduce their mortgage test from the 15 percent standard generally acceptable to lenders to 10 percent. This has unfairly cut our bond interest coverage ratios in comparison with other companies. It has also tended to affect adversely investors' perceptions of our credit worthiness, resulting in higher interest costs on debt and more expense to ratepayers.

Companies subject to the Holding Company Act must include sinking and improvement fund and replacement fund provisions for bonds. To implement these provisions is the cause that this Statement of Policy was adopted many, many years ago. The market long ago ceased to care about these funds and, in fact, fears early redemption of bonds through these provisions. Most electric utilities have eliminated these funds from their current and future financings and are, therefore, more attractive to investors.

In addition, the Statement of Policy regarding preferred stock and the practice of the Commission in implementing policy have imposed on us a number of rigid requirements which, absent unusual circumstances, have significantly limited the ability of companies regulated under the act to vary the terms of preferred stock to meet changing market conditions.

These include, among others, the requirements (1) that provisions restricting redemption of preferred stock can only be for a period of up to 5 years and must be limited to refunding with lower cost money; (2) that optional redemption prices for preferred stock must conform to a formula set forth in the Statement of Policy; (3) that mandatory sinking funds for the redemption of preferred stock must be calculated to retire not more than 5 percent of the issue each year beginning with the fifth year after issuance; and (4) that the holders of preferred stock be entitled to certain voting rights. In addition, the Statement of Policy regarding preferred stock generally limits the amount of short-term unsecured debt for companies issuing preferred stock to not more than 10 percent of capitalization.

Senator D'AMATO. Mr. Lewis, your 10 minutes has expired, and I'm wondering, in the interest of the other panelists, if you couldn't summarize in a minute or two the balance of your testimony. We will put into the record your testimony in its entirety.

Mr. LEWIS. All right, sir. There are many cases in which the SEC staff has gotten into what amounts to management decisions. I would cite you the case in our system where we have tow boats and barges that move oil. There are times when we don't need those.

They tell us on what basis we can off-charter these to reduce the carrying cost, the layup cost. They insist that it must be very short term rather than long term no matter what our judgment might be as to how long would be the best from an economic standpoint.

They've taken much the same position in the case of subleasing unit trains for the movement of coal.

I cite an instance in here where we were prevented from taking an equity position in the construction of a grassroots, from the ground up, petroleum refinery in which it was sold about the time it was finished. The entrepreneurs who put in equity capital substantially tripled their money. We had put in the key element of capital into that denominated as an advance payment for fuel. We got back exactly dollar for dollar what we had put in. The others tripled their money. Now I submit that the application of the Holding Company Act in that situation was neither in the interest of investors, nor of ratepayers.

There are restrictions on who you can have as a director of any company in a holding company system which applies to commercial banking connections. I put in an illustration of an outstanding businessman who agreed to serve on one of our companies and the SEC would have none of that because he happened to be a member of the board of the Bank of New York. We had never done any business with them. It had no bearing on our situation. They have very rigid rules on who you can have as a director.

A real current illustration—we're going to put on a World's Fair in New Orleans in 1984. It happens I'm president of that group. We're financing it by getting corporations to give us guarantees which will underlie a bank line of credit. We were able to go out and put together about $40 million worth of guarantees, all kinds of companies.

To my knowledge, the only companies that had to come to Washington and ask the SEC for permission to enter into that transaction which was all of $2.5 million maximum exposure were the companies of the Middle South System. Now I submit to you that it doesn't make much sense on trivial matters, in a relative sense, like that, that the SEC has to sit in judgment whether management is making a good decision or not.

The bottom line I guess is that those of us that are still under the Holding Company Act feel that it is almost totally duplicative of other regulations to which we are subject; the State commissions are well able to look after ratepayers and do their own auditing and investigating, and what we would ask is that this act, which was good, which well served its purpose, completed that 20 years ago, ought to be taken off the books and off the back of that segment of the industry which has to still bear it.

(Complete statement follows.)

STATEMENT BY FLOYD W. LEWIS, CHAIRMAN AND PRESIDENT, MIDDLE SOUTH UTILITIES, INC.

Mr. Chairman and members of the Committee, I appreciate the opportunity to appear before you in support of S. 1977, Senator Johnston's bill to repeal the Public Utility Holding Company Act of 1935 (the 1935 Act). I am Floyd W. Lewis, Chairman and President of Middle South Utilities, Inc., which is one of the 12 holding company systems still fully regulated under the 1935 Act. I appear on behalf of the Edison Electric Institute (EEI), the association of investor-owned electric utility companies. Its membership is composed of substantially all of the investor-owned electric utility companies in the country, and they provide about 77 percent of the nation's electric service.

We agree with the position of the Securities and Exchange Commission (SEC) as expressed by the Chairman in his letter to Senator D'Amato, dated December 21, 1981, that ". . . this statute (the 1935 Act) has served its basic purpose and that continued federal regulation of utility holding companies is unnecessary and inappropriate."

We also agree with the following additional points which the SEC made in its letter:

That "the Commission's task of reorganizing the Nation's gas and electric utility holding company systems was completed twenty years ago."

That "The Commission's administration of the Act in more recent years has primarily involved review of registered holding company financings, mergers, and acquisitions and the consideration of requests for exemptions from the Act."

That "these abuses (which lead to the original passage of the Act) are unlikely to recur in light of the extensive changes since 1935 in the public utility and investment banking industries, the accounting profession, state utility regulation, expansion of the disclosure requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934, and the development of more efficient and well-informed securities markets."

That "If the 1935 Act is repealed, all publicly-owned utility holding company systems will, of course, continue to be subject to the financial disclosure requirements and other provisions of the federal securities laws."

That "unlike the other statutes it administers, the 1935 Act involves the Commission very deeply in the substance of fundamental management decisions."

That "only twelve active holding company systems remain subject to direct regulation under the 1935 Act. The Act, however, continues to have significant influence on the financing and management decisions of a much larger portion of the industry. Approximately 80 holding company systems operate under various exemptions from the Act, and many utilities may be reluctant to form holding companies because they would then have to register under the Act or qualify for an exemption."

A copy of Chairman Shad's letter is attached to my testimony.

We should start our examination of why the 1935 Act should be repealed by a review of what the 1935 Act does.

The 1935 Act requires that all holding companies with subsidiaries engaged in any aspect of the electric utility business or in the retail distribution of natural gas register with the SEC, the agency with authority to enforce the 1935 Act. There are some exemptions from the registration provisions which will be discussed below. Presently twelve holding companies fall within the registration provision: Allegheny Power System, American Electric Power Co., Central and Southwest Corp., Columbia Gas System Inc., Consolidated Natural Gas Co., Eastern Utilities Associates, General Public Utilities Corp., Middle South Utilities, Inc., National Fuel Gas Co., New England Electric System, Northeast Utilities, and The Southern Co. Nine are electric utility systems and three are gas utility systems. In terms of 1981 gross revenues, the nine represent about 20 percent of the investor-owned electric utility industry and the three represent about 8 percent of the gas utility industry.

Only a small number of companies are registered holding companies because most holding companies fall within the exemptions of the 1935 Act. Approximately eighty holding companies are in the exempt group. However, it is most important to recognize that these exemptions are discretionary. Holding companies may enjoy the freedom offered by these exemptions only so long as the SEC finds them appropriate.

The 1935 Act subjects holding companies to two principal kinds of regulation. First, the complex organizations that existed then were simplified, and holding company utility operations were integrated by spinning off geographically unconnected operations. The SEC completed the task of simplifying holding company structures by 1952 and the regulated holding companies of today bear no resemblence to the conglomerates that prompted enactment of the 1935 Act.

Second, the company must obtain SEC approval for most financial and many operational transactions. The filings proposing transactions and the regular reports required to be filed with the SEC to prevent the recurrence of abuses, such as self-dealing, stock-watering, and other types of asset manipulation that occurred in a different era more than a half century ago, is the principal current activity of the SEC in enforcing the 1935 Act.

To understand why such legislation was enacted, we must examine the environment at that time.

In the 1920's the utility industry was undergoing a period of major growth. Since the SEC was not established until 1933, the securities of utilities and of all other industries were not subject to regulation. The boom mentality which pervaded the entire decade and the lack of effective security regulation created a classic speculative bubble.

Utility rates and many other practices that are regulated today were also not subject to regulation. State regulatory agencies at that time were few and very poorly staffed—as late as 1935 there were still only 22 states that regulated rates. Court decisions strictly limited state regulatory authority and there was no Federal commission, such as the FERC, that regulated utilities' interstate rates. Moreover, the courts were particularly liberal in allowing utilities to set a value on their own property for purposes of ratemaking, sales or security issuance. With little regulation on either the state or Federal level, an unsophisticated investing public, and a rapidly expanding industry, the scene was ripe for security violations.

The main use and abuse of the holding company form of organization that precipitated the 1935 act was the use of a small controlling interest as a means of controlling large amounts of capital through what is known as "pyramiding." When the giant Insull utility trust collapsed in 1929, there were more than 10 layers between the operating companies and the controlling group at the top. Using these methods, individuals and groups were able to control large collections of capital with only small amounts of their own actual investment. The Congress did recognize that there are many advantages of a holding company form of organization to both investors and consumers, such as providing greater stability of earnings by evening out the variable performance of the different operating subsidiaries of a company due to different sales patterns, the extent of involvement in a construction program, or the results of local regulation.

To address the widespread abuses in the entire securities industry, the Congress enacted the Securities Act of 1933 and the Exchange Act of 1934 (1933 and 1934 securities acts), which require disclosure of a variety of information when a security is publicly distributed and held. These acts are extensive and the SEC enforcement of them is vigorous. As a result, investors are protected from unscruplous dealings because of the detailed disclosure requirements of these acts. These acts are the backbone of the effective securities regulation we enjoy today. In many cases, the 1935 Act merely duplicates the provisions of these acts.

For instance, the SEC now requires utilities to utilize specific accounting standards and specific forms and contents of financial statements included in SEC filings. The SEC derives its authority to require these forms from the 1933 and 1934 securities acts. While the 1935 Act provides similar authority, the SEC does not rely upon the 1935 Act authority but uses its other authorities to require uniform accounting standards for public utility companies. Moreover, uniform accounting standards are required by the Federal Energy Regulatory Commission (FERC) for its regulation of the industry. Thus, the 1935 Act is not needed to prevent asset manipulation, overcapitalization, or other accounting abuses. In addition, the development of a sophisticated accounting industry has led to the adoption of uniform accounting standards for all industries and businesses.

In retrospect, the 1933 and 1934 securities acts with their disclosure requirements and the development of professional accounting standards would have been sufficient to reveal which utilities were on a sound financial basis and which were not. Individual investors armed with this information would reject companies that were overcapitalized.

The 1935 Act was passed principally because Congress wanted an orderly dismantling of the complex and far-flung holding company systems in existence at that time into simpler organizations and also because Congress did not know what great successes the 1933 and 1934 securities acts would be in curbing security abuses. There was no track record under these acts at the time the 1935 Act was passed.

Another provision that Congress included in the 1935 Act provides that transactions among affiliates in a holding company system come under SEC regulation. However, both the FERC and state public utility commissions now have the authority to scrutinize such affiliate transactions. The FERC's authority to set wholesale rates gives it the ability to examine the amounts paid to affiliates by utilities and to disallow expenses that are found to be unreasonable. State public utility commissions also currently have the authority to examine the reasonableness of expenses incurred or property added to the rate base of individual utilities whether through transactions with affiliates or otherwise.

Any claim that state public utility commissions cannot control affiliate transactions is of questionable validity. If the reasonableness of a particular transaction is not shown, they can disallow that expenditure from the computation of allowed rates, thus striking at the heart of a utility's operations. Various of the utility regulatory commissions of the states in which Middle South's subsidiary utilities operate, Arkansas, Louisiana, Mississippi and Missouri, have reviewed the financial records of our service subsidiary and our fuels company to examine the basis for changes between System companies. It is instructive to note that they have performed their own audits of affiliates and have not relied upon the SEC.

The abuses that arose during the 1920's that resulted in the passage of the 1935 Act represented a unique period of economic history which could not be repeated today for a number of reasons, not the least of which is effective state and federal regulation of the utility industry which has developed over the last 47 years. The amount of intense scrutiny that utility companies receive today from sources other than the SEC holding company staff is more than sufficient. The 1935 Act is a prime example of legislation which has served its purpose and, because of changed circumstances over the 47 years since its enactment, is no longer needed and should be repealed.

Some might argue that, since essentially all of the requirements of the Holding Company Act are embodied in other legislation, there is no reason to repeal the Act. They would say that, precisely because the Act is currently duplicative, repeal of the Act would be of small benefit.

I would take issue with those arguments on both philosophical and practical grounds. We believe that existing laws and regulations should be justified. In a period when our troubled economy is burdened with heavy regulatory costs which contribute to the weakness of our industrial capacity, and when Congressmen are forced to make extremely tough, unpleasant choices among programs which serve real needs, we believe that the burden of proof must be borne by those who want to keep regulation in place. They should be required to present substantial evidence that the laws and/or regulations in question are still needed, not just that they don't do much harm.

We submit that since attainment of its basic objectives, the 1935 Act has done harm. The 1935 Act which was set up to protect investors and ratepayers has often produced results to their detriment. We will endeavor to show this by reference to experience under the Act, in many instances referring to my own company.

The requirements of the 1935 Act are wasteful. The estimated expenses incurred by the Middle South System associated with the various Holding Company Act filings for the one-year period June 30, 1980, through June 30, 1981, total $465,000. Other registered holding companies doubtless incur comparable costs, and these are only the direct costs to utilities and do not include the cost of lost opportunities due to regulatory red tape.

SEC approval is required for numerous regular transactions ranging from sale and leaseback of oil storage tanks to the establishment of a bank line of credit. The provisions and policies of the Holding Company Act have impaired the financing activities and operations of companies subject to the Act and, as a result, have adversely affected management flexibility and the competitive position of such companies in relation to non-holding company utilities. Generally, in addition to the time required for preparation of a filing, there is at least a 60-day waiting period between initial filing and receipt of an order under the 1935 Act permitting the transaction. Because of these long delays, registered holding companies and their subsidiaries are unable to take advantage of "windows" in the financial markets and many transactions with "short fuses" never get off the ground, thus preventing management from further reducing the cost of capital. Other companies with which we must compete in the financial markets do not have this extra burden.

We can see no circumstances where there is real need for the filing of a Registration Statement under the 1933 Act and also the presently required filing under the 1935 Act. Many other filings are duplicative also. Companies subject to the 1935 Act are required to file an Annual Report, Form U5-S, with the SEC. In addition, the same companies are required to file an Annual Report, Form 10-K, with the SEC under the 1934 Act. The reports include duplicative information. This puts an unnecessary burden on the companies to render the same information twice to the SEC and as a result increases costs to the companies and thier customers.

In the area of financing, the Holding Company Act dictates numerous requirements which, singularly and in the aggregate, have limited the ability of the registered companies to tailor the terms of their securities to reflect the frequent and sudden changes occurring in the volatile securities markets. Several of these deserving of further discussion are the competitive bidding requirements under the Act in connection with sales of securities and the formal Statements of Policy under the Act governing the terms of First Mortgage Bonds and Preferred Stock.

Rule 50 under the Holding Company Act in general precludes the issuance and sale of securities except pursuant to competitive bidding. This requires publication of a formal invitation for bids and the receipt of competitive proposals for the purchase of securities at least 6 days after publication. Absent unusual circumstances or adverse market conditions, registered holding companies and their subsidiaries have been precluded from engaging in negotiated public offerings of securities or private placement transactions, financing alternatives which have been and are available to many other electric utilities.

The Statement of Policy Regarding First Mortgage Bonds has tended to make those companies which are regulated under the Holding Company Act less competitive in the market place, resulting in higher interest costs to the borrowing company and, therefore, higher costs to ratepayers. These restrictions generally are not desired by investors. In fact, some restrictions required under the Act may result in higher interest demands by investors.

For example, under the Holding Company Act, a company must comply with redemption restrictions in an era when a creative response to market conditions would dictate other redemption provisions. Other utilities have been able to negotiate the circumstances under which a particular series of bonds would be redeemable. Companies subject to the Act are limited to a restriction on optional redemption prices which has not satisfied many investors in this volatile market. Potential investors appear to be greatly concerned about the possibility that their bonds might be redeemed before they become due. Our inability to respond to these concerns is costly.

Companies subject to the Holding Company Act are further burdened by the Statement of Policy's artificial limit on earnings that may be counted in determining whether a company may issue First Mortgage Bonds. For example, under the Act, no more than 10 percent of the earnings used to meet the issuance test generally required on utility bonds can come from a source other than utility revenues. The industry norm allows this figure to be 15 percent. Yet, under the Act, companies are forced to reduce their mortgage test from the 15 percent standard generally acceptable to lenders to 10 percent. This has unfairly cut our bond interest coverage ratios in comparison with other companies which have a 15 percent standard. It has also tended to affect adversely investors' perceptions of our credit worthiness, resulting in higher interest costs on debt and more expense to ratepayers.

Companies subject to the Holding Company Act must include sinking and improvement fund and replacement fund provisions for bonds. The market long ago ceased to care about these funds and, in fact, fears early redemption of bonds through these provisions. Most electric utilities have eliminated these funds from their current and future financings and are, therefore, more attractive to investors.

In addition, Holding Company Act companies must use property to meet the requirements of these funds which could otherwise be available to support issuance of additional debt. This, again, puts us at a great disadvantage in relation to our fellow utilities. With the same amount of property, we have less ability to issue bonds, a fact which may be perceived by the market as making us a higher credit risk.

In addition, the Statement of Policy Regarding Preferred Stock and the practice of the Commission in implementing the Statement of Policy have imposed on us a number of rigid requirements which, absent unusual circumstances, have significantly limited the ability of companies regulated under the Act to vary the terms of Preferred Stock to meet changing market conditions. These include, among others, the requirements (1) that provisions restricting redemption of Preferred Stock can only be for a period of up to five years and must be limited to refunding with lower cost money, (2) that optional redemption prices for Preferred Stock must conform to a formula set forth in the Statement of Policy, (3) that mandatory sinking funds for the redemption of Preferred Stock must be calculated to retire not more than 5 percent of the issue each year beginning with the fifth year after issuance, and (4) that the holders of Preferred Stock be entitled to certain voting rights. In addition, the Statement of Policy Regarding Preferred Stock generally limits the amount of short-term unsecured debt for companies issuing Preferred Stock to not more than 10 percent of capitalization. In addition to these limitations, companies regulated under the Holding Company Act have long been precluded from developing other types of financing, including sales of convertible debt securities or, for those companies with Preferred Stock outstanding, sales of debentures. Also, companies subject to the Act have been precluded from creating and selling a lesser grade of preferred Stock generally known as "Preference Stock." At a time of increasing market volatility and heavy capital requirements, companies need maximum flexibility in terms of financing arrangements. The foregoing restrictions serve only to limit management's financing alternatives.

At one point in time, on the recommendation of a director whose financial experience and expertise are truly outstanding, the Board of Middle South Utilities, Inc. concluded that the best means of raising capital then being contemplated was by means of issuance of convertible debentures. The chief financial officer was instructed to pursue this matter with the staff of the SEC. He reported that they said they would not approve the proposed plan of financing. After further consideration by the Board of Directors, he was asked to go back to Washington and explore the matter again. My recollection is that he was told that they could not prevent us from making a formal filing but that if we did the staff would see that the matter received a full-blown, drawn-out referral to and hearing by the full Commission. The need to go forward in raising capital on a timely basis forced us to acquiese in the staff's position. I submit this as an illustration of how the SEC staff, by using delaying tactics, can if it chooses, and in many cases it does, substitute its judgment for that of the management and directors of a company subject to the Holding Company Act.

In addition to restrictions on financing, the Holding Company Act has hindered the operations of the Middle South System in a number of other areas. Allow me to cite a few examples.

Mississippi Power & Light Company had entered into an arrangement with Mississippi Fuel Co. in 1973 for the construction and operation in the State of Mississippi of a pipeline to transport natural gas for use as boiler fuel in certain MP&L generating units. Due to changes in fuel supplies, by 1979 only 50 percent of the capacity of the pipeline was being used to transport natural gas. MP&L desired to enter into long-term arrangements with third parties to transport natural gas but due to the Holding Company Act was restricted to only those arrangements of a limited duration which could be terminated or suspended at any time by MP&L for its own needs. This has reduced the opportunity to make use of the pipeline for third parties.

Owing to similar considerations under the Holding Company Act in 1976 when tow boats and barges acquired or leased by the Middle South System were not required, due to changes in fuel supply, to be used for transporting oil for use in Middle South System generating stations, the System was only permitted to subcharter these boats and barges on a temporary rather than long-term basis, thereby reducing sub-chartering opportunities. The same position has been taken by the SEC staff under the Holding Company Act with respect to unit trains which the Middle South System leases to transport coal from the western United States to its generating units. These unit trains are seasonally surplus to the System's needs and yet the requirements of the Holding Company Act have restricted the System's ability to sublease the trains fully during times of such surplus.

In 1975, Arkansas Power & Light Company had a supply of uranium which it had purchased at less than $8 a pound and which was excess to its needs. The then present market value was approximately $25 per pound. AP&L desired to sell this uranium to its sister company, Middle South Energy, Inc. at fair market value to obtain the benefits of the profit. Owing to the restrictions in the Holding Company Act, AP&L's options, however, were limited solely to the sale to MSE at cost.

In 1974, pursuant to national policy that additional domestic petroleum refining capacity should be encouraged, the Middle South System worked with certain entrepreneurs in putting together perhaps the largest grass roots refinery project ever in the United States. It was located on the Mississippi River upstream from New Orleans and would satisfy a significant portion of the fuel oil requirements of the Middle South System which were made necessary beause of gas supply curtailments alleged to be pursuant to Federal regulations. Because of the rigidity of the restrictions on entry of companies subject to the Holding Company Act into any other businesses, the Middle South System, even though it provided the key capital component, was prevented from taking an equity position in the refinery. We had to structure our essential capital input as an advance payment for oil to be delivered over approximately a decade. About the time of completion, the refinery was bought by Marathon Oil, with the entrepreneur equity holders realizing a very substantial capital gain. Our System got back only the $67 million which has been advanced with no gain at all. I submit that neither investors nor customers were benefited by the Holding Company Act preventing our having taken an equity position and shared in the handsome gain realized.

In 1972, System Fuels, Inc. was organized as a fuel subsidiary in the Middle South System to plan and implement programs for the procurement of fuel supplies for the System. As originally established under the Holding Company Act, SFI was permitted to engage in efforts for the development and procurement of oil and gas supplies and other fuels, and for the transportation, handling and storage of these fuels, pursuant to general programs approved under the Act covering periods of several years, thereby affording the management of SFI Substantial flexibility in the carrying out of its fuel programs. In more recent years, however, the SEC holding company staff has stepped up its regulation of the System's fuels activities and the management of SFI has been burdened with having to justify on a yearly basis, with detailed budgets and descriptions of future developments in its fuels programs, its continued operation and estimated future financing requirements. This increased regulation has worked to inhibit management's ability to make and implement timely decisions.

Another area in which the Holding Company Act and the regulation under it impose a decided handicap on companies subject to the Act as compared to other electric utilities are the very stringent retrictions on commercial banking connections for directors. About 12 or so years ago when I was President of Louisiana Power & Light Company, I was able to secure the agreement of Mr. John G. Phillips, President of Louisiana Land and Exploration Company, to join the Board of Directors of Louisiana Power & Light Company. He was already well recognized as one of the outstanding business leaders of the New Orleans area and very prominent in the civic life of the community. He was at that time serving as a director of the Bank of New York, an institution with which Louisiana Power & Light Company had no banking relationship. Feeling that Mr. Phillips would be a most valuable addition to the Louisiana Power & Light Company Board of Directors, we requested the SEC to approve our electing him. The request was summarily rejected by the SEC staff as not meeting any of the specific criteria of the Categories of Exemptions in Rule U-70. Since that time, Mr. Phillips has become Chairman and Chief Executive Officer of Louisiana Land and Exploration Company, has been elected to the board of The Travelers Insurance Company, to the board of Allis-Chalmers Corporation, and became Chairman of the Board of Administrators of Tulane University. In the latter role, he brought the University's fiscal condition from a pattern of well over 10 years of unending deficit operations to operations in the black during the last two most difficult of years. It is difficult to see how denying us the services as a Director of this outstanding business executive has served the best interests of anyone, and particularly the investors and customers of our System. One of the classes of exemptions for directors having commercial banking connections is with a banking institution having combined capital and surplus not in excess of $2.5 million. That number has been unchanged for 36 years notwithstanding the effects of inflation and the growth of banking institutions.

A number of years ago, the Middle South System sought to implement a Stock Option Plan to help attract and hold talented executive personnel within the System. It encountered substantial regulatory resistance and was able to implement a modified plan over the objections of the SEC staff only after protracted proceedings and carrying the matter all the way to the Securities and Exchange Commission itself. Why should a public utility holding company and its subsidiaries be treated any differently than other electric utilities, or any other business for that matter, on matters such as the use of stock options as part of a compensation plan? Why should members of the SEC staff sit in judgment on such matters, which in any event must be submitted to the shareholders of the corporation for a vote?

A very recent example involves guaranties by Middle South Utilities, Louisiana Power & Light Company, and New Orleans Public Service Inc. in connection with Bank financing for the 1984 Louisiana World Exposition. Of all the corporations, companies, and individuals who have signed such guaranties which support a bank line of credit for this World Exposition, only the three companies of the Middle South Utilities System were required to file with the SEC and request permission for a matter involving only a total of $2.5 million of maximum exposure. This was made necessary by the fact that the definition of a "security" under the Holding Company Act is so broad that it encompasses a guaranty of this sort.

I submit that in all of the instances cited, the investor's or the consumer's interests were not well served by regulation under the Holding Company Act.

We cannot see how passage of S. 1977 could harm any consumer's interest. The consumer's interest rests on the utility's ability to provide adequate and reliable service at reasonable rates. As a consequence, the consumer is fundamentally dependent on and benefits from (1) effective and efficient utility management and (2) effective rate regulation; the repeal of the 1935 Act would not erode the latter and would most likely strengthen the former. The consumer also benefits when (3) the costs of regulation are reduced, and (4) the costs of opportunities lost to utilities are minimized; repeal is also likely to result in such benefits.

Federal and state rate regulators have primary responsibility for ensuring that customer rates reflect only legitimate costs of utility service. The repeal of the 1935

Act would not diminish the existing powers of rate-making authorities to fulfill that responsibility.

Both state and federal rate regulators have considerable experience in setting reasonable rates for customers of utilities affiliated with non-utility businesses. Standardized accounting practices, coupled with auditing and enforcement authority, have enabled rate regulators to routinely allocate the costs of capital, goods and management services between utility and non-utility businesses.

As we have discussed before, consumers may also be concerned that repeal of the 1935 Act will eliminate controls over charges paid in affiliate transactions. But that concern is misplaced. The 1935 Act does require intercompany tranactions to be undertaken at cost, limiting any profit to affiliates paid by utility companies. However, over 80 percent of the U.S. electric utility industry is exempt from this requirement. Their customers have historically relied on ratemaking authorities to scrutinize affiliate transactions to prevent abusive transfer charges. No discernible impairment of consumer interests has resulted from this reliance. Again, existing rate regulatory powers are adequate to deal with questions in this area.

We find it hard to believe any argument that, after repeal of the 1935 Act, there would be insufficient regulation. We believe that excessive and unwise regulation is a prime reason that the electric utility industry today faces a grave financial crisis. Our stock prices are below book value, our achieved rates of return are inadequate, and our credit ratings trend steadily downward. The bond issues of some utilites are now being rated too low to qualify for institutional investment portfolios, further reducing their marketability and increasing their interest rates. In 1980, the average return on common equity allowed by regulatory bodies was 14.3 percent. The average return actually earned in 1980 was only 11.4 percent.

It is clear the the utility industry's financial condition must be improved or everyone, investors and consumers, will suffer. We are not asking for a handout. We are only asking for the removal of an unnecessary part of the heavy regulatory burden we must bear. Senator Johnston's bill S. 1977 would accomplish this and, at the same time, reduce unnecessary government expenditures that could be applied to more urgent needs. We urge the passage of S. 1977.

Senator D'AMATO. Thank you very much, Mr. Lewis.

Mr. Luntey.

STATEMENT OF EUGENE LUNTEY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE BROOKLYN UNION GAS CO., ON BEHALF OF AMERICAN GAS ASSOCIATION, ACCOMPANIED BY RICHARD ROSAN, SPECIAL CONSULTANT TO AGA; AND ANDREA R. HILLIARD, AGA MANAGER AND COUNSEL OF LEGISLATIVE AND REGULATORY AFFAIRS

Mr. LUNTEY. Thank you, Senator. I am Eugene H. Luntey, president and chief executive officer of the Brooklyn Union Gas Co., and chairman of the American Gas Association's board of directors. I am accompanied today by Richard Rosan, special consultant to the American Gas Association (I might mention that Mr. Rosan was for many years associated with Columbia Gas and has wide experience concerning the Holding Company Act) and by Andrea Hilliard, AGA's manager and counsel of legislative and regulatory affairs.

[Complete statement follows:]

TESTIMONY OF EUGENE H. LUNTEY, PRESIDENT AND CHIEF EXECUTIVE OFFICER OF THE BROOKLYN UNION GAS CO.

INTRODUCTION

I am Eugene H. Luntey, President and Chief Executive Officer of the Brooklyn Union Gas Company, and Chairman of A.G.A.'s Board of Directors. I am accompanied by Richard Rosan, Special Consultant to the American Gas Association (A.G.A.), and by Andrea R. Hilliard, A.G.A.'s Manager and Counsel of Legislative and Regulatory Affairs.

The American Gas Association is a national trade association which represents nearly 300 natural gas distribution and transmission companies serving over 160 million consumers in all 50 states. Collectively A.G.A. member companies account for nearly 85% of the nation's total gas utility sales annually.

I am pleased to provide you with our industry's views on the proposed legislation[1] to amend or repeal the Public Utility Holding Company Act of 1935 (PUHCA).[2]

Natural gas currently provides about 27 percent of the energy consumed in the U.S. Gas is used in about 55 percent of all domestic residential and commercial establishments, and it provides 40 percent of the energy consumed by domestic industry, including agriculture. Almost all gas used in the U.S. is produced domestically, and natural gas provides two and one-half times as much end use energy to consumers as electricity. Thus, natural gas is a vital part of this country's fuel mix.

A.G.A. member companies are affected in different ways by the Act. Three of our member companies[3] remain registered under the Act. Well over 60 of our member companies are exempt holding companies under the Act. The remaining distribution member companies, including my own company, are not covered by the Act, although some would like to change to a holding company corporate structure but choose not to do so for fear of falling under the Act. Thus, A.G.A.'s testimony will focus upon repeal of the Act, as has been proposed in S. 1977 (Johnston, D-LA). I will discuss why total repeal of the Act is necessary and what its impact on our industry will be.

REPEAL OF PUHCA AND THE NEED FOR MEANINGFUL REGULATORY REFORM

A.G.A. views PUHCA as one additional overlay of unnecessary federal regulation that is hampering the ability of the natural gas industry to take its proper place in providing a greater part of this nation's fuel mix. We view our support of PUHCA repeal as part of our overall industry desire to streamline the regulatory process, thereby enhancing our ability to obtain adequate gas supplies and provide adequate utility service reliably and efficiently. A.G.A. has taken a strong role in encouraging Congress to adopt responsible regulatory reform legislation. We have also supported the Administration in its efforts to enforce its own initaitive for regulatory reform through implementation of E.O. 12291.[4] Finally, A.G.A. has taken an active role in previous and ongoing Congressional efforts to streamline the permit process for major energy facilities in the form of "fast track" licensing proposals such as contained in H.R. 3236 by Congressmen Morris Udall (D-AZ) and Manuel Lujan (R-NM).

One principal effect of existing overregulation is to discourage the industry from participating in new energy projects because of the difficulties of getting major energy facilities licensed in a timely fashion. Regulatory delays and uncertainties can hinder the ability of this industry to provide its proper share of the nation's future energy needs and to perform related system maintenance and construction. A recent A.G.A. study estimates that this industry must make a cumulative capital investment of $482 billion (in 1982 dollars) to provide this industry's share of energy through the year 2000.[5] Overregulation at the federal and state levels will make it extremely difficult for this industry to attract the new capital necessary to meet these capital needs. Much of this capital must be invested in exploration and development of new gas reserves and new supply sources, such as SNG and LNG.

Many gas companies would like to move into exploration, production and other supply projects (e.g., coal gasification) or into marketing projects, such as jointly-owned user/utility cogeneration facilites, low Btu on-site gasification facilities or natural gas-powered vehicles. Such diversification into gas utility related activities is important in order that these enterprises can show a satisfactory earnings growth and thereby maintain the financial strength so necessary for a capital intensive industry. This financial strength enhances the attraction of capital at lower costs. However, as we will discuss later in detail, the Act may impede or prevent regulated and exempt holding companies from pursuing these kinds of needed corporate strategies. In addition, it will probably deter other gas utilities from adopting a holding company structure which my be essential for pursuing—efficiently and profitably—such activities.

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[1] S. 1869 (D'Amato, R-NY and Johnston, D-LA) would amend the Act to reduce substantially SEC oversight and regulation of the existing registered gas and electric holding companies. S. 1870 (D'Amato, R-NY and Johnston, D-LA) would amend PUHCA to benefit certain exempt holding companies by allowing them greater latitude in developing corporate strategies for diversification. S. 1871 (D'Amato, R-NY and Johnston, D-LA) would amend the Act to preclude its application most gas utility holding companies. S. 1977 (Johnston, D-LA) would repeal the Act in toto.

[2] 15 U.S.C. 79.

[3] Columbia Gas Systems, Inc., Consolidated Natural Gas Company and National Fuel Gas Company.

[4] Executive Order No. 12291, 46 Fed. Reg. 13193 (Feb. 19, 1981).

[5] "Energy Analysis: A Forecast of Capital Requirements of the U.S. Gas Utility Industry to the Year 2000: 1982 Update," American Gas Association, Arlington, Va. (1982).

Thus, repeal of PUHCA would provide important relief for the regulated natural gas industry. At a time when many voices are urging Congress and the Administration to streamline regulation, PUHCA should be repealed since it places needless impediments in the operations of many gas companies. We emphasize needless impediments, because the gas consumer will be protected, both as to service and rates, after repeal of PUHCA. In other words, today PUHCA is not necessary to protect the consumer, the public, and the investor in their areas of critical interest.

WHY PUHCA SHOULD BE REPEALED

Congress enacted PUHCA in 1935 at a time when many practices of public utility holding companies were detrimental to the interest of utility consumers and investors. Part of the current impetus for repealing the Act comes from the fact that the practices cited as justifying the Act in 1935 have been eliminated. Under the Securities Act of 1933 and the Securities Exchange Act of 1934,[6] administered by the Securities and Exchange Commission (SEC), all companies with publicly issued securities, including holding companies, are required to disclose operating and financial data on their companies and subsidiaries using a uniform system of accounts. This now allows investment analysts and investors to make reasoned and informed investment decisions prior to investing in holding companies and their subsidiaries. Additionally, states have become more active in regulating utility subsidiaries of holding companies and have the power to investigate and control intercompany transactions, with the result that state commissions have adequate information and power to regulate proper charges to utilities by their parents or affiliates.

Gas and electric utilities must now comply with a uniform system of accounts at the federal and state levels. This assures that investment in plant facilities at original cost and all operating expenses are properly and uniformly recorded. Because of this important development, state commissions can effectively regulate utility rates, and investors and the general public have an accurate report of a company's operating results and balance sheet account. The Natural Gas Act of 1938[7] assures that the activities of interstate gas pipelines are regulated closely. This fills a gap which, in 1935, hampered regulation of gas utilities. Finally, all companies, including holding companies, with securities issued under the federal securities laws and listed on major stock exchanges, are subject to more stringent scrutiny by the investment community than was the case in 1935. In short, the Act has served its purpose of creating simplified corporate structures of holding companies; because of the comprehensive scrutiny of corporate practices by the investment community, the possibility of repetition of past bad practices is remote. Most of the purposes and provisions of the Act are now covered by other federal and state statutes and regulations. Thus, the Act is not necessary.

EFFECT OF TOTAL REPEAL

The Act applies to gas holding company systems with subsidiaries which sell natural gas at retail. There are two types of utility holding companies under PUHCA—registered and exempt.[8] The Act provides substantial impediments for both types of holding company systems.

For registered holding companies, there are substantial limitations on the activities of companies within the holding company system, as well as on acquisitions of new companies. A registered holding company is subject to certain restrictions on security transactions (including loan guarantees) between the public utility, its parent and sister subsidiaries. The issuance of acquisition of a registered holding company's own securities or those of its public utility subsidiaries, even if not offered to the public, cannot be accomplished without filing for and receiving SEC approval under both the 1933 and the 1935 Acts.

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[6] 1933 Act—15 U.S.C. 79a. 1934 Act—15 U.S.C 97b.

[7] 15 U.S.C. 717.

[8] Registered holding companies are holding companies which, for a variety of reasons, have remained subject to the Act's stringent limitations. Exempt holding companies are those which have satisfied one of the five exemption criteria, such as being a predominately intrastate utility, provided under Section 3 of the Act.

Potential acquisitions by registered holding companies are limited by the Act. In addition to requiring that there be a functional relationship between the holding company's utility activities and the proposed acquisition, the Act's procedural requirements can severely hamper a registered utility's exploration and development efforts or other forms of supply acquisition activities. For example, if a registered holding company offers to acquire a drilling company (a proper functional activity for a gas utility system), such a transaction requires that the holding company file an application with the SEC setting forth all the terms and conditions of the contract and thereafter, such information must be published in the Federal Register.[9] Members of the general public can request a public hearing that may delay SEC approval of the acquisition. This approval requirement places the registered holding company at a severe competitive disadvantage in competing with other potential buyers. First, the necessity for SEC approval and the time required to obtain such approval may dissuade the seller from entering into the contract. Second, public disclosure of the terms and conditions may permit other bidders for the drilling company to out-maneuver the holding company. This is an example of how a registered holding company seeking to secure adequate supplies for its consumers by moving into exploration and development activities can be thwarted by application of the Act.

Joint ventures are an important way of accumulating the capital necessary to construct major energy facilities, such as new pipeline systems, coal gasification or other highly capital-intensive supply projects. This will certainly increase if the $482 billion (1982 dollars) capital requirement is realized to meet supply projections by the year 2000. Nevertheless, until recently, registered holding companies have had great difficulty in finding participants for joint ventures willing to run the risk of being considered by the SEC as being covered by the Act merely by virtue of their joint participation with a registered holding company. In 1980, the SEC adopted Rule 16,[10] which prevents joint participants from being drawn into the Act so long as the registered holding company owns no more than 50% of the joint venture. Nevertheless, the Act has served as a deterrent to joint ventures.

Aside from some of these substantive obstacles posed by the Act, there are innumerable duplicative and unnecessary reporting requirements and applications that are time-consuming and costly. Eventually, the consumer must bear the cost of this paperwork.

The Act does not have as pervasive an impact on the operation of exempt holding companies as it does on registered holding companies. For example, an exempt company does not have to file the numerous applications required of registered holding companies with respect to routine day-to-day activities which are within a company's normal operating prerogatives. Futhermore, relationships between the parent holding company and its utility subsidiaries and other affiliates are not as closely scrutinized as they are for registered holding companies. Nevertheless, the Act remains as a substantial impediment for exempt holding companies.

For example, various acquisitions by exempt holding companies remain subject to Section 3(a)'s "unless and except" clause. This clause is extremely vague regarding the magnitude and form of diversification and permits the SEC to "second guess" the exempt holding company's management regarding the desirability of these acquisitions, an ability which it does not possess for other companies. This exposure to possible forced divestiture or loss of exemption imposes significant limitations on an exempt holding company's efforts to diversify into profitable activities.

There is no present justification for a statute like the PUHCA to govern the non-utility activities of a holding company, some or all of whose subsidiaries are confined to the distribution of natural gas at retail. For example, the Federal Energy Regulatory Commission (FERC) regulates the gas transmission and storage activities of interstate gas pipelines, many of whom are heavily engaged in exploration and development efforts and other related businesses. The FERC has effectively regulated their jurisdictional activities in a manner which assures that the ratepayer has not been hurt by the non-regulated activities of such pipelines. This is also true of distribution utilities that have engaged in gas-related or non-gas-related activities. State regulation of the utility function has been effective.

For these reasons, A.G.A. has concluded that the PUHCA is not necessary in the public interest; to the contrary, it is duplicative of other federal laws, it requires unnecessary and costly paperwork, and it places registered gas holding companies at a competitive disadvantage when trying to engage in activities that will benefit the gas consumer. Finally, diversification of various types of activities—some closely related and others less closely related to the successful marketing of gas—is important for the financial health of the gas industry. PUHCA unnecessarily impedes these efforts.

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[9] 17 C.F.R. 250.23(e).

[10] 17 C.F.R. 250.16.

CONCLUSION

Other witnesses from the gas industry you will hear in future hearings will discuss in greater detail the impact of the Act on the utility industry, on holding company systems and upon the public interest. Many of these witnesses will focus upon specific proposals pending before Congress, and the impact of those proposals upon the natural gas industry. We urge this Subcommittee to support full repeal of the Public Utility Holding Company Act of 1935.

Thank you for this opportunity to present our views to the Subcommittee on this important issue.

Senator D'AMATO. Thank you very much.

Mr. Richardson.

STATEMENT OF ALAN RICHARDSON, LEGISLATIVE DIRECTOR AND COUNSEL, AMERICAN PUBLIC POWER ASSOCIATION, ACCOMPANIED BY GEORGE SPIEGEL, ESQ., SPIEGEL & McDIARMID

Mr. RICHARDSON. Thank you, Mr. Chairman.

Senator D'AMATO. Mr. Richardson, I count up to page 188, so if you can summarize ——

Mr. RICHARDSON. Mr. Chairman, I don't intend to read my statement.

Senator D'AMATO. I would ask you to summarize it and we would ask that the record contain your statement in its entirety.

Mr. RICHARDSON. I am accompanied here today by Mr. George Spiegel of the law firm of Spiegel McDiarmid. He's available because of his extensive experience in using this act on behalf of municipal electric systems and he's available to assist in answering questions.

My name is Alan Richardson and I am the legislative director and legislative counsel for the American Public Power Association. We represent over 1,750 local power systems throughout the country.

CRITICAL ELEMENTS

Let me start, Mr. Chairman, with what I think are probably the most critical elements in this entire debate over the Holding Company Act: First, the power business is a public business, regardless of its ownership. Electric power is essential to public health, life and economic survival. Second, the electric utility industry operates under monopoly conditions. The combination of these two factors, necessity and monopoly, creates a business affected with public interest and the business itself is public and not private.

Now competition regulates free enterprise, and free choice in the marketplace exercised by consumers daily determines which companies are going to survive and which won't. But with the exception of a very few communities where there is actually street-to-street competition for electric service, there is no free choice for electric power supply. Electric companies are granted an exclusive franchise and if you want to turn on your lights you have only one company to go to.

Because of this, government regulation is set up to act as a substitute for competition. It sets rates and takes other actions to protect investors and consumers alike.

Few would dispute that the Holding Company Act was absolutely necessary to protect investors and consumers when it was passed by Congress in 1935, but let's not lose sight of the fact that this was a very, very hard fought battle in 1[illegible], and certainly the companies that eventually became subject to the act were vigorous and very strong opponents of provisions of the act, including in particular section 11. Since then, the industry has been restructured and holding company empires which controlled about 85 percent of the utility industry have been broken up. Today there are only nine electric holding companies which are registered under the Act. But these nine companies represent 20 percent of the utility industry. In contrast, Mr. Chairman, public power systems represent about 14 percent of the electric utility industry. These nine companies hold 60 utilities, 39 utility companies, and they all operate in interstate commerce. The registered companies, the exempt companies and those which choose not to form holding companies because they would then be subject to the act seek substantial modification or, better yet, repeal.

It's up to you to determine whether conditions have so changed that this 50-year-old regulatory program is no longer necessary. Certainly conditions have changed, but what has not changed is the two essential elements of regulation—necessity and monopoly are still present.

Now the decisions which have to be made are yours. We don't think that a case has been made for amendment or repeal of the act, but certainly our interest will be substantially affected depending upon your actions.

Over 900 local public power systems purchase power at wholesale from investor-owned utilities. In many cases, these systems are as much a captive to their power supplier as the individual residential customer. As customers, we believe the repeal or substantial modification of the act could significantly increase our power costs. Regulatory controls at the state level are not adequate to control affiliate transactions of registered companies.

Failures in diversification ventures could increase costs of utility service. Overly successful diversification could occur at the expense of the utility through diversion of capital and managerial attention, leaving a weakened utility system which management might then simply want to spinoff.

Our interest in this act extends, however, beyond our relationship as customers of the investor-owned utilities and customers who have received protections under this act. It has a very important antitrust and anticonglomerate aspect which has prevented concentration of control in the bulk power market.

Public power systems have used the act to their benefit and the benefit of their customers. I cite two specific examples of this in my prepared testimony.

BASIC ARGUMENTS FOR REPEAL

Those who would have the act be repealed or substantially modified essentially present two basic arguments. First, they say the act is redundant or obsolete, an anachronism, it has simply outlived its usefulness; and, second, they say it prevents or inhibits diversification which is a corporate strategy which they want available to them to improve the poor financial health of the utility industry. I've addressed both of these arguments in considerable detail in my prepared remarks, but I would like to summarize a few of the main points.

We do not think the act is redundant. It's certainly not duplicated by the provisions of the Securities Act of 1933 and 1934. We think it serves a useful purpose. The Chairman of the SEC in his letter to you of last year in calling for repeal of the act in fact noted that there are many provisions of the act which do set it apart from the other securities statutes. The SEC's functions are not duplicated at the State level and the State commissions could not fill the regulatory vacuum left by repeal of the Holding Company Act.

The National Association of Regulatory Utility Commissioners in a 1972 report on diversification concluded that controls at the Federal level need to be strengthened and electric and gas distribution companies should continue to be subject to the Holding Company Act when part of a holding company system.

That was not their latest expression, however, for earlier this year their executive committee adopted a resolution on this issue which States: First, that State commissions rely on the 1935 act to assist them in effective regulation of electric and gas utilities within their jurisdictions and; second, the changes contemplated in bills pending before the Congress may seriously jeopardize the ability of state commissions to regulate these utilities. That same resolution goes on to urge the Chairman of the SEC and the other members of the commission to reconsider their position on repeal.

Now we hear a great deal about regulatory burdens, however, we don't think the regulatory burdens are that significant. The actual cost of filings required by the SEC is a miniscule fraction of the total assets for the annual operating revenues of the registered companies. These are multibillion corporations.

In addition, we believe there are beneficial results from the SEC's regulation under the act. Registered companies have a simple corporate structure which in turn we believe has promoted investor understanding and confidence and resulted in lower cost of capital.

Opening the door to diversification is not an adequate justification for repeal. As a practical matter, exempt companies can and do diversify into nonfunctionally related enterprises. Multi-State companies which have not already used the holding company structure can diversify without becoming subject to the act. This path, incidentally, has been followed by Pacific Power and Light and I think it's very relevant to note that their chairman and chief executive officer was recently quoted as stating that diversification is a path that has more dangers than it does opportunities.

Only the registered companies are restricted as to diversification ventures and these restrictions prohibit them from entering into areas other than those which are functionally related.

DIVERSIFICATION POSES SOME RISKS

Several arguments have been advanced to suggest that diversification benefits electric utility investors and their consumers. All are postulated on the assumption that the diversification ventures will be successful. They ignore the consequences of unsuccessful diversification which can be severe. I think we need only turn back 10 years to look at the Penn Central case and see this.

Diversification may attract, stimulate and maintain better quality management. It may also divert management's attention from the essential public business of producing and selling kilowatts. The 1972 NARUC report concluded that diversification may be beneficial or it may be detrimental from the investor's perspective. For the consumer, however, the risks are there but not the benefit.

Diversification into functionally related businesses may be appropriate, but utility experience in the area of captive coal mines suggests that even here there are risks. A recent FERC study on utility-owned coal mines revealed that utilities pay significantly more for their own coal than the utilities purchasing coal from non-captive sources.

In conclusion, Mr. Chairman, let me say we are not opposed, per se, to diversification. We are opposed, however, to diversifications where there is not an adequate protection against the risks which those diversifications do pose. We believe these risks were recognized and properly dealt with by the Congress in the 1935 act and we see no reason for repeal or modification.

Senator D'AMATO. Did you say repeal or modification?

Mr. RICHARDSON. Yes.

Senator D'AMATO. Do you see any basis for modification of the act?

Mr. RICHARDSON. Mr. Chairman, the Holding Company Act does present some restrictions on both registered companies and on exempt companies. While I personally think that a utility should be in the utility business, that's my own personal bias and not necessarily the opinions of other people who are in this business.

It seems to me, however, that if diversification is the goal, then there are ways which this can be accomplished through minor modifications to the Holding Company Act.

For example, registered companies might be allowed to diversify into nonfunctionally related businesses subject to the approval and review of the SEC. I think that if that is the case, then certainly the size of their diversification venture should be limited so that it does not approach in magnitude the size of the utility operation which is after all their reason for being.

I think latitude exists within the Commission at present to undertake a rulemaking proceeding to establish proper limits for diversification into nonfunctionally related areas by exempt holding companies. If there is a realistic fear by exempt holding companies that the Commission is going to come in and grab away their exemption, perhaps the appropriate thing for the Congress to do is to suggest that the SEC undertake a rulemaking proceeding, assuming that it does have that authority, and establish reasonable limits for diversification, again subject to the Commission's control.

Senator D'AMATO. I'd like to come back to this later

[Complete statement of Mr. Richardson follows.]

STATEMENT OF ALAN H. RICHARDSON, LEGISLATIVE DIRECTOR AND COUNCIL, AMERICAN PUBLIC POWER ASSOCIATION

Mr. Chairman, members of the Subcommittee, my name is Alan H. Richardson. I am the Legislative Director and Legislative Counsel for the American Public Power Association. APPA is the national service organization representing over 1,750 local public power systems in 48 states, Puerto Rico, Guam, American Samoa, and the Virgin Islands. I am pleased to have the opportunity to testify before you today on three bills to amend the Public Utility Holding company Act of 1935 (S. 1869, S. 1870, S. 1871). The three bills affect different segments of the utility industry—registered holding companies, exempt holding companies and natural gas holding companies. Taken together, they would so significantly reduce the authority of the Securities and Exchange Commission under the Act that they amount to de facto repeal. Repeal, of course, is proposed in another bill before the subcommittee, S. 1977. All of these measures raise the very important policy question of the current validity of this 47 year old statute.

APPA is concerned that the adoption of S. 1869 and S. 1870, which deal with electric utility holding companies, or the repeal of the 1935 Act proposed by S. 1977s would have serious adverse consequences for electric consumers in general and municipal electric systems in particular. More than 900 local public power systems throughout the country purchase some or all of their power from investor owned utilities. Removal of the regulatory constraints imposed by Congress on electric utility holding companies in order to protect the interests of investors, consumers and the public alike, could significantly increase the cost of wholesale power for these public power systems. Moreover, the Act is an effective anti-conglomerate, anti-takeover statute which has been effectively used by public power systems to prevent the concentration of control of the bulk power market in the hands of the few largest utility systems.

As evidence of our concern over amendments to this Act, I have attached to my testimony a resolution adopted by the membership of the Association at its annual conference in San Francisco in 1981 (Exhibit A). While the resolution specifically addresses amendments to the Act being advocated by the registered holding companies and embodied in S. 1869, the "resolved" clause is much more expansive. Our members have directed APPA to opposed any amendments to the Act unless they can be demonstrated to benefit consumers of the public utility holding companies.

Those who advocate amendment or repeal of the Act advance two major arguments. First, they suggest that the Act has accomplished its primary purpose. The massive holding company empires, whose financial abuses and anti-competitive practices led to its passage in 1935, have been dismembered. Other regulatory bodies at the state and Federal level, and other provisions of law such as the Securities Acts of 1933 and 1934, have, they say, eliminated the necessity for futher regulation pursuant to the provisions of the 1935 Act. In short, they say the Act is redundant, imposes additional regulatory burdens which are costly and unnecessary, and repeal is warranted.

Second, they argue that the Act is an impediment to utility diversification into other business ventures. The opportunity to engage in diversification programs, unrestrained by the Act and the SEC, is regarded as a solution for the financial problems confronting the utility industry. Presumably, through diversification will come better management, stronger financial health and, ultimately, lower costs for utility consumers. We do not believe that these arguments are supported by the facts.

THE ACT IS NOT REDUNDANT

In evaluating the argument that the Act is redundant, it is necessary first to bear in mind precisely which utility holding companies are subject to SEC regulation. It was not the purpose of Congress to displace state with Federal regulation where state regulation could be presumed to be adequate. Such presumptions were made by the Congress on the basis of geographic factors, and utilities meeting these geographic conditions are entitled to exemptions (unless they operate in a fashion detrimental to the public interest or the interest of investors and consumers). (Sec. 3(a)) Only in those cases where, due to the multi-state nature of the registered holding companies, single state regulation was clearly inadequate, were the regulatory provisions of the Act to be applied.

When the Act was passed, nearly 85 percent of the electric utility industry was subject to reorganization and divestiture. Today, only nine registered electric utility holding companies remain. While few in number, these companies hold sixty electric utility systems. (They also control 38 non-utility but functionally related enterprises.) These sixty companies, in turn, represent approximately 20 percent of the nation's utility industry, with assets in 1980 in excess of $48 billion, and operating revenues approaching $17 billion. Their size, and more significantly, their multistate character, demands regulation in an effective and coordinated manner. While the individual states can and do regulate the rates of these systems, to suggest that the individual state commissions can or will regulate these multi-state companies in a fashion consistent with maintaining the financial simplicity of the overall holding company is a difficult argument to accept. Even if one does accept this argument, it seems to make little sense to force several commissions to do what is now being done effectively by one.

Investor owned utilities would have us believe that the functions of the SEC under the Holding Company Act can be adequately performed by state regulators. WE cannot overemphasize the importance of giving considerable weight to views of the state regulators themselves on this issue. Regulated holding companies have an obvious self-interest in suggesting that they are over-regulated and urging that these "regulatory burdens" be reduced or eliminated. We believe the state commissions are in a much better position to evaluate their own capabilities and determine whether the Federal role under the Holding Company Act continues to be appropriate and in the public interest.

In 1971, the National Association of Regulatory Utility Commissioners (NARUC) established an ad hoc committee on non-utility investments chaired by Joseph Swidler, former chairman of the Federal Power Commission and, at that time, chairman of the New York Public Service Commission. The ad hoc committee delivered its report at NARUC's Eighty-Fourth Annual Convention in 1972. (Portions of the report are attached as Exhibit B.) After an exhaustive study of diversification and regulation of utilities, the ad hoc committee concluded that "there is a need to strengthen controls over public utility diversification at both the state and Federal levels." In its conclusions and recommendations, the ad hoc committee stated that "in situations where state commission control is impractical, diversification by gas, electric, telephone and water utilities should be controlled by appropriate Federal agencies.

"Specifically: Electric power companies and local gas distribution companies should continue to be subject to the Public Utility Holding Company Act where they are components of public utility holding company systems."

Conditions change, and pronouncements in 1972 may not be valid in 1982. Recognizing this, the Swidler committee recommended that NARUC reexamine the issues of regulation and diversification in the future. As you undoubtedly know, such a review is now underway under the direction of Stanley York, Chairman, Wisconsin Public Service Commission. The final report of this ad hoc committee will not be available until July, 1982. It appears at this point, however, that the York committee will agree with the conclusions of the 1972 committee concerning the inadequacy of state regulatory control over multi-state holding companies and the necessity for continued Federal regulation under the 1935 Act.

An indication of NARUC's views on this issue are contained in a resolution recently adopted by the NARUC Executive Committee. That resolution states in part that "many state public utility regulatory commissions rely on provisions of the Act to assist in the effective regulation of electric and gas utilities within their jurisdictions." Further, "the contemplated changes in the Act may seriously jeopardize the ability of state commissions to regulate these utilities."

The NARUC Executive Committee felt it appropriate to adopt this resolution prior to completion of the ad hoc committee report in view of the SEC position calling for repeal of the 1935 Act. The resolution itself concludes with the recommendation that the SEC "reconsider its position." In a letter transmitting this resolution to SEC Chairman John S. R. Shad, Chairman York stated that the NARUC ad hoc committee "will take a firm position on the need for the Act." (The York letter and accompanying NARUC resolution is attached as Exhibit C.)

REGULATION OF AFFILIATE TRANSACTIONS

Regulation of affiliate transactions highlights the unique and extremely important role played by the SEC under the 1935 Act in protecting utility consumers;

forcefully demonstrating why the Act is necessary. Regulation of these transactions is, of course, one of the primary reasons why the registered companies would like the Act repealed or modified.

Under the Act, transactions between affiliates within a registered holding company system generally must be based on actual cost of service plus a reasonable return. (The SEC does have discretionary authority to modify this where appropriate. They recently exercised this authority in a case involving the New England Electric System.) In view of the multi-state nature of the registered holding companies, and the resultant inability of state commissions to control transactions between affiliates, we believe the Act is not only appropriate, but absolutely necessary to protect utility ratepayers. Loading of charges by service companies on the utility was, after all, one of the abuses giving rise to the 1935 Act.

Proponents of repeal suggest that it is inequitable to subject only a portion of the electric utility industry to such controls, and further that such transactions are effectively regulated by other commissions—state and Federal. Again, we would point out that the regulated holding companies represent approximately 20 percent of the utility industry, control sixty electric companies and 38 functionally related businesses, all of which operate in interstate commerce.

For interstate companies, state commissions may have the ability to determine how and to what extent affiliate transactions will be regulated. It is difficult, however, for state commissions to control interstate transactions. (Even if they can at present, or could in the future through passage of additional legislation, exert sufficient control over these multi-state companies in order to protect the public and consumers, why should they be forced to do so when effective controls exist at the Federal level?)

It is clear to us that not all affiliate transactions are being dealt with effectively by state commissions or by the Federal Energy Regulatory Commission. In February, 1982, FERC issued a staff report entitled "Automatic Adjustment Clauses in Public Utility Rate Schedules" which included a review of the transactions between utilities and their affiliate coal companies. (A copy of relevant portions of the FERC report, which included a summary of a 1980 FERC report on state regulatory oversight of electric utility associate fuel companies is attached as Exhibit D.)

The FERC report concluded that "many of the state PUC's have limited resources with which to regulate affiliate coal operation effectively." The dangers to the consumer of inadequate regulation of these transactions are apparent. The FERC study noted, for example, that "transactions between a utility and its affiliate fuel company do not usually result from a process of arms-length bargaining by independent parties . . . (so) the possibility exists that affiliate profits may exceed reasonable levels or that subsidiary operations may be technically inefficient and consequently, utilities will be burdened with excessively high fuel prices." A survey of 36 state commissions revealed that "in some states, commissions appear to lack the authority to deal with affiliates. Many PUC's also lack the resources necessary to undertake the additional responsibilities of thourough investigations. Inadequate reporting and recording requirements and the resulting lack of systematic information contribute to regulatory problems."

In addition to state commissions, the FERC has some jurisdiction over prices paid for captive coal. However, FERC regulations require that it defer to other regulatory bodies where fuel is purchased from a captive mine and the price is subject to the jurisdiction of another regulatory body. The 1982 FERC report, however, indicated that "deferral to another regulatory body may not provide adequate assurance of reasonable rates and may not alert the Commission to situations involving unreasonable rates."

The SEC does have jurisdiction over captive coal prices in cases involving registered holding companies. True, this involvement is limited. As noted in the 1982 FERC report, "only 13 utilities of the 39 utilities involved in captive coal in 1978 are members of holding companies." These 13 companies, however, "used almost 50 percent of all the captive coal produced in 1978."

The FERC report clearly reveals that there are holes in the regulation of prices for coal from captive mines. (We believe we are justified in assuming from this that there are likewise holes in regulating other transactions between affiliates.) The solution to this problem, which may cause utilities and their customers to be "burdened with excessively high fuel prices" is certainly not to repeal a statute designed to prevent such high prices. Rather, means should be devised to ensure that consumers receive the protections to which they are entitled.

Registered holding companies also object to the requirement that affiliate profits earned on transactions with independent third parties must be applied to reduce charges for services rendered to the utility. This is clearly appropriate in view of the purpose of the Act and the abusive practices it was designed to eliminate. If these profits were not balanced against costs, cost of utility service would increase. In addition, and more important from a regulatory standpoint, problems of appropriate cost allocation and transfer pricing would arise.

THE "REGULATORY BURDEN" ARGUMENT

Proponents of repeal further suggest the consumers will benefit from removing the cost of an additional layer of regulation by the Securities and Exchange Commission. These costs appear to be insignificant and are more than offset by the benefits afforded by SEC regulation. Registered companies have stated that compliance costs amount to $½ million or more per year. For a small business, these costs might be a real burden. However, the registered holding companies are not small businesses. In 1980, American Electric Power Company had assets of $10.9 billion and operating revenues of approximately $3.7 billion; Middle South had assets of $7.3 billion and operating revenues of $2.3 billion; and The Southern Company had assets of $11.4 billion and operating revenues of $3.7 billion.

At the same time the registered companies are complaining about compliance costs, they are also saying that the materials required to be filed under the Holding Company Act are largely duplicated by filings required by the SEC under the Federal securities laws. To the extent that their "duplicate filing" argument is valid, the financial burdens on the registered companies will not be significantly reduced by eliminating this one statute.

Duplicate regulation under the 1935 Act and the Federal securities laws is another argument advanced as justification for repeal of the Holding Company Act. While reporting requirements may be similar, it is incorrect to suggest that that the Federal securities laws obviate the necessity for the Holding Company Act. This fact is evident in the December 1981 letter of SEC Chairman Shad to the Chairman of this Subcommittee. In that letter Chairman Shad stated "moreover, certain features of the 1935 act set it apart from the other statutes which the Commission administers. The Federal securities laws focus primarily on disclosures to investors and on the integrity of the securities markets. In contrast, acquisitions, financings and other actions by registered public utility holding company systems require prior commission approval under the 1935 Act. The commission must base its approval or disapproval of these transactions on its determination of their economic merits."

Against the burdens imposed by the Act, this Committee must weigh the benefits which have accrued to investors, consumers, and the general public. In contrast to the complicated financial structure of the holding company systems in the '30's, today's holding company systems operate in a straight-forward and uncomplicated manner. We believe that the uniform, simple, capital structure of the existing holding companies have promoted investor confidence and have helped to hold down the cost of capital. Because of their straightforward and simple capital structure these systems have a higher investment quality and therefore lower cost of capital. We are not persuaded by the argument that because the systems have a simple capital structure today, they will continue to have such a capital structure tomorrow should the Act be repealed. It is not beyond the realm of possibility that the abuses which gave rise to the Act could recur in its absence.

Registered companies have argued that repeal would reduce the cost of opportunities which are lost to them due to the Act. For example, they suggest that SEC regulation of their financing prohibits them from entering the market at the most favorable time and has thus increased their cost of capital. Some time ago, however, the SEC adopted a policy of encouraging registered companies to pre-file financing programs covering a one-year period. Through one order, the financing program can be approved. Utilities are then free to enter the market at the most propitious time. Notwithstanding this, however, we believe that the only way that this Committee can effectively evaluate this argument is to require registered companies to demonstrate how they have in fact suffered financially as a result of SEC regulation. We believe that SEC review of proposed financial offerings has resulted in companies restructuring their offerings to the ultimate financial benefit of the holding company system itself. We thus urge this Committee to inquire into both the costs and the benefits which flow from SEC approval of financial offerings.

MUNICIPAL UTILITY INTEREST

It would be difficult, if not impossible, to convince municipal electric systems that the Act is redundant—that it serves no useful purpose. In the recent past public power systems have intervened in SEC proceedings involving acquisition of utility property by other electric utilities. These interventions have prevented concentration of control in the wholesale power market and have guaranteed municipal systems access to wholesale power.

For example, the American Electric Power Company petitioned the commission to approve the acquisition of the Columbus and Southern Ohio Electric Company. The SEC recognized that the vulnerability of municipal electric utilities in Ohio would be increased by the acquisition because of the increased concentration in the electric bulk-power market. Consequently, the SEC's approval of the acqusition was conditioned on a settlement which provided that AEP would either build or sell generating capacity to the municipal systems. The condition was considered to be so material to the SEC approval that it delayed entry of an order granting AEP's application until it was provided with further assurance that the settlement was capable of being executed and the municipal electric systems protected.

In another case, several investor owned utilities in New England requested SEC approval of stock acquisition in two nuclear generating companies which they were organizing. This acquisition was opposed by several Massachusetts municipal electric systems which contended the SEC should require the companies to permit participation by municipal electric systems on the same terms provided for the sponsor companies. The municipals argued that without such an opportunity, the venture violated anti-trust laws.

The SEC initially refused to consider this argument. On appeal, the U.S. Court of Appeals for the District of Columbia agreed with the municipalities. The Court held that the SEC could not determine that the acquisition was in the public interest without examining the effect on competition of concentrating supply of low cost bulk power in the hands of investor owned utilities. The case was subsequently resolved when the investor owned systems were required under the authority of the Holding Company Act to permit municipal systems to buy into new generating companies.

Because the New England case involved nuclear generating facilities, it has been suggested that the anti-trust review provisions of the Atomic Energy Act are an adequate substitute for SEC authority under the 1935 Act. This argument, however, ignores the fact that there are no anti-trust review provisions regarding the construction of major conventional bulk power facilities.

UTILITY DIVERSIFICATION

Diversification into non-utility businesses to improve the financial condition of the nation's electric utilities is the most frequently advanced argument for repeal or major modification of the 1935 Act. The New York law firm of Reid and Priest, on behalf of a large number of exempt electric utility holding companies, suggested in a memo dated September 21, 1981, that allowing public utilities to diversify into other "more profitable business fields" represents a "simple near term measure that ameliorates the problem" of the unhealthy financial condition of the electric utility industry.

Diversification is by no means a simple solution. Don C. Frisbee, Chairman and Chief Executive Officer of Pacific Power and Light, one of the most widely diversified electric utilities which derives 46 percent of its operating income from non-electric businesses, recently conceded "you can make more mistakes in new business." He stated further "I am not an advocate of diversification for utility companies. Generally speaking it is a path that has more dangers than opportunities because of the difficulties of trying to mix a typical management approach to the highly regulated utility business with the entrepreneurial approach needed in unregulated arenas." (See Business Week, January 18, 1982 "Pacific Power and Light: Still Diversifying as Electric Use Slows" page 58). (In the same article Stanley T. Skinner, Executive Vice President of Pacific Gas and Electric Company states "I think diversification is something of a cop-out.")

Those who advocate utility diversification as a solution to the poor financial health of the investor owned utility industry present several arguments. These arguments were all addressed and, for the most part dismissed, by the 1972 NARUC ad hoc committee on non-utility investment. (See Exhibit B)

The arguments supporting diversification, and the rebuttals contained in the NARUC report, may be summarized as follows:

1. The freedom to diversify into more profitable business will improve the overall financial condition of the holding company, reduce capital costs and benefit utility customers. The NARUC ad hoc committee found this argument "not persuasive." Earnings from non-utility sources are considered riskier than those from utility sources. Thus diversification may in fact increase the cost of capital. Further the argument is based on the questionable assumption that the new venture will be

profitable. If the venture is unprofitable, however, then it may harm the overall financial condition of the holding company, increase capital cost, and hurt the utility customers.

2. Diversification of risk will enhance access to capital which will in turn facilitate public utility financing. The NARUC Committee concluded that in some cases this argument may have merit, but it is generally not true for large electric power companies. In any event, diversification of risk is a policy designed to protect investors, not utility customers. Thus, with respect to diversification of risks, the NARUC committee report states as follows: "If a public utility engages in substantial diversificiation and is successful, the principle beneficiary is the stockholder and not the utility consumer. If diversification proves to be unsuccessful, the stockholder is injured and the risk is great that the utility customer will be injured as well. The stockholders of a utility may win or lose as a result of diversification but the consumer bears the risk of failure without any commensurate participation in the benefits of success."

3. Diversification is necessary to attract and retain highly competent management. An equally valid counter argument is that diversification dilutes managerial attention and, to the extent management is concerned with non-utility operations, the utility operation may suffer. These arguments, according to the NARUC report, cancel one another out.

We believe that the problem of diversion of managerial attention to non-utility operations could have extremely serious consequences. In a speech before the New York Society of Security Analysts on February 17, 1982, the Edison Electric Institute President William McCollam, Jr. stated that investor owned utilities project a five year construction program which will cost a total of $165 billion. Investments of this magnitude demand that utility management attention not be diverted to other areas.

It is equally important that capital not be diverted from utility to non-utility investment. The problems of accurate load forecasting are by now common knowledge. A relatively small change in load growth compounded each year during the several years required to bring a new plant on line can have an incredible impact on a utility's ability to meet its demand. It is conceivable that management might be less than objective in evaluating load growth forecasts, selecting lower growth projections in order to have more capital to invest in diversified ventures. If capital is so diverted, new capacity might not be available when needed.

The 1972 NARUC report was not completely negative with respect to diversification. It did suggest that diversification into functionally related activities where there were joint products, by-products and complimentary services might well be appropriate.

But even in this area, diversification should not be unrestrained. First, the activity should clearly be functionally related to utility service. For example, utilities might diversify into the fuel supply area, and as a corollary acquire means of transporting the fuel from the source to the generating station.

Second, the NARUC committee report suggested that the functionally related activities should not approach the size utility operations. Third, the NARUC committee concluded that the activity must not violate anti-trust standards.

Experience over the past 10 years, however, had indicated that diversification into functionally related areas, for example fuel supply, have not always operated to the benefit of the utility. The FERC study on automatic adjustment clauses (Exhibit D) addresses the issue of utility captive coal mining operations. The report indicates that "(1) captive coal prices are on average significantly higher than comparable non-captive coal prices; (2) captive coal mines appear to be operating less efficiently than comparable non-captive coal mines; and (3) regulation of electric utility affiliated coal operations may be inadequate to assure the efficient management of captive mines and the reasonableness of the captive coal prices."

Diversification does pose risks. That fact can't be disputed. The more than 900 public power systems who purchase power at wholesale are, like other utility customers, captives of the supplying utility. They are entitled to adequate regulatory protection from the potential adverse consequences of diversification. It is possible that wholesale power bills could increase in any number of ways: failure of the diversified venture; improper allocation of common utility and non-utility costs; inappropriate transfer pricing; spin-off of a utility system should management conclude that diversified ventures are far more profitable. We strongly believe that the Holding Company Act either actively as is applies to registered companies or as restraint in the case of exempt companies provides us with such regulatory protection.

SPECIFIC LEGISLATIVE PROPOSALS

At this point I would like to turn to the specific measures pending before this Subcommittee.

S. 1977

Quite obviously APPA disagrees with both the Congressional findings and the proposed repeal of the Holding Company Act contained in S. 1977. Without restating all the arguments advanced above, we would offer the following comments on the recommended Congressional findings in S. 1977:

1. We agree that the Act does subject utility holding companies to a level of regulation not found necessary for other organizations in the same or related industries. Because utility service is a twentieth century necessity, however, we believe that such regulation is not only appropriate but essential.
2. We agree that the holding company empires which gave rise to the passage of the Act have been dismantled. We also agree that the capital structures of the few remaining registered holding companies have been simplified. We are not convinced, however, that the abuses prevalent in the late '20's and '30's would not recur should the Act be repealed. Further, we do not believe that the multistate holding companies can be effectively regulated without the 1935 Act.
3. While only a small number of holding companies are regulated under the Act, these companies represent nearly 20 percent of the electric utility industry and consist of 60 operating electric utility systems. Because of their multi-state nature it is appropriate that they be regulated as single entities. State regulation is inadequate to accomplish this purpose. Control over these multi-state organizations can only be exercised by the Federal government.
4. We do not agree that the Securities Act of 1933 and Securities Exchange Act of 1934 are adequate substitutes for the protections afforded investors, consumers and the public by the Holding Company Act of 1935. Nor do we believe that state regulatory commissions have, for the most part, either the authority or the ability to review acquisitions and transactions entered into by public utility operating companies and their affiliates, particularly when these companies are multi-state in nature.
5. We do not believe that the Holding Company Act inhibits innovation. It does appropriately inhibit unrestrained diversification. These restrictions are entirely appropriate. Diversification presents risks for utility consumers. They stand to gain little and lose a great deal should diversification prove unsuccessful. If, however, the Congress should conclude that diversification is appropriate, modest changes in the Holding Company Act can be adopted to permit this to occur while at the same time protecting the interest of investors, consumers and the public.

S. 1869

S. 1869 would make three major modifications in the regulation of registered companies under the 1935 Act. First it would significantly modify the provisions on financial offerings of registered companies. Public utility subsidiaries could issue securities, including guarantees, where the purpose is to finance either the business of the subsidiary, or another subsidiary, within the same holding company system. This modification could open the door to cross subsidization between subsidiaries.

Another major modification would be to allow registered systems to guarantee securities issued by a non-utility subsidiary. The aggregate amount of these guarantees could not exceed 10 percent of the total capital surplus and principal and par value of the securities of the registered holding companies which were then outstanding. This provision would make the holding company liable for the contingent liability of its subsidiary companies. In the event of default, the parent holding company would have to make good on the guarantee, or, in the alternative, the non-utility subsidiary may have to draw from the utility operation. While 10 percent may seem modest, it must be remembered that these holding company systems are multi-billion dollar corporations and default, even at the level of 10 percent, could have a very significant adverse effect on the utility and its customers.

The SEC would have some authority to adopt rules establishing requirements relating to the security structure of a registered company in order to prevent any "unsound financial practice." This term, defined in S.1869, is extremely vague, relating to a financial practice which would cause an unreasonable risk to investors or consumers. We are puzzled as to how one would define an unreasonable risk to consumers. Investors take risks; consumers should be protected from them.

The second major modification proposed in S. 1869 would permit registered companies to diversify into non-functionally related areas without even the review, much less the approval, of the SEC. APPA supports the conclusions of the 1972 NARUC committee report to the effect that diversification should be restricted to functionally related enterprises. Even then, these enterprises should not be overly large with respect to the total utility operation and should be consistent with antitrust laws and other public policies.

However, the Congress may conclude that diversification into non-functionally related businesses by registered companies is to be permitted. In that event we urge the Congress to grant the SEC the authority to monitor, limit, and if appropriate order divestiture of non-utility investments when it is clear that the holding company is no longer operating in the best interests of the investors, consumers and the public.

Finally, S. 1869 would permit transactions between subsidiaries based on market price for the sale of such goods or services rather than on actual cost. Further, the SEC would be prohibited from crediting to the utility the profits made by a subsidiary when dealing with third parties. The Act currently requires the commission to adopt rules to ensure that contracts between affiliates are performed economically and efficiently for the benefit of such associate companies, at costs which are fairly and equitably allocated among those companies. Under this authority the Commission has repeatedly required that profits from functionally related businesses earned in transactions with companies outside of the holding company system should be used to reduce the cost of goods or services provided by that company to the utility. As stated previously, we believe this is sound public policy and should not be altered.

S. 1870

S. 1870 is applicable only to exempt holding companies and would (1) eliminate the authority of the SEC to withdraw an exemption once granted, and (2) provide two new categories for exemptions.

Under section 3 of the 1935 Act, the Commission may exempt utility holding companies if they meet certain qualifications. These exemptions remain in effect "unless and except insofar as it (the Commission) finds the exemption is detrimental to the public interest or the interest of investors or consumers." APPA can see no conceivable justification for removing this authority.

Exempt companies argue that the "unless and except" provision has a chilling effect on their diversification plans. Fear of loss of the exemption has caused them to take a cautious approach to diversification. We will accept this argument, but hasten to point out that unrestrained diversification might result in financial disaster rather than financial salvation. (Certainly the Penn Central disaster of the early 1970's is ample proof of this fact).

Exempt holding companies can and do diversify into areas which are not functionally related. They believe, however, that at some point the Commission may arbitrarily and capriciously withdraw the exemption, subjecting them to the full requirements of the Act, including divestiture.

We do not believe arbitrary and capricious actions would be tolerated, by the Commission, the courts or Congress. The "unless and except" clause can only be utilized when it is found that the exemption is "detrimental to the public interest or the interests of investor or consumers". Legislative history as well as provisions of the Act, specifically provisions contained in section 1(b), provide considerable guidance to the Commission in determining when actions may be found to be detrimental to the interest of investors, consumers and the public.

This "arbitrary withdrawal" argument was made during debate over provisions of the Pacific Northwest Electric Power Planing and Conservation Act during the 96th Congress. In that case, investor owned systems in the Pacific Northwest desired an exemption from the 1935 Act in order to establish regional generating companies within a holding company structure. The Congress refused to grant a blanket exemption. Instead, it provided a conditional exemption subject to withdrawal by the SEC should the generating companies fail to abide by the policies of the Holding Company Act. The investor owned utilities objected, arguing that the policies were vague, and arbitrary withdrawal a realistic possibility.

The House Committee on Interstate and Foreign Commerce disagreed, pointing in particular to section 1(b). The Committee report, (Rept. 96-976. part 1) noted that the "the term 'policies' of the 1935 Act is not defined by the Committee. The agencies (Bonneville and the SEC) are, obviously, given some leeway to define them in light of the Act and its application today and in the future. The bill places a duty on both agencies. The Committee expects that it will be exercised properly and fairly, but with effect" (Report, p. 73).

We believe the Congress was then, and is today, fully justified in placing its trust in the discretion of one of its own creations. Should that trust be abused, the Congress can react appropriately.

In addition, the Commission has addressed itself to the question of exemption withdrawal in Pacific Lighting Corporation, 45 SEC 152 (1973). This decision provides guidance to exempt companies who desire to diversify.

If the diversification venture is successful, we can't believe the SEC would suggest the exemption should be withdrawn. The very fact that the exempt companies fear withdrawal of their exemption is, in effect, an admission against interest. They are saying that diversification may not be successful, may adversely affect the interests of their investors and consumers. Yet notwithstanding this, they feel they should continue to remain exempt. By requesting the repeal of the "unless and except" clause these exempt companies are requesting flexibility to diversify without restraint. Yet they would deny comparable flexibility for the SEC to react to changed circumstances detrimental to the interest of investors, consumers or the public.

We do not believe the standards for exemption are vague. If the Congress believes otherwise, the Commission could be directed to institute rulemaking proceedings, under the guidance of specific statutory provision, which will further clarify the matter.

CONCLUSION

In conclusion, APPA is convinced that the 1935 Act continues to serve a very beneficial purpose. It has protected the interests of investors, consumers and the public for nearly fifty years. It has prevented the concentration of control in the electric bulk power market. Public power systems have benefited from this anti-conglomerate feature of the Act. It assists the state commissions in the exercise of their regulatory responsibilities. It properly restricts, actively or passively, utility diversification.

The Congress, of course, may disagree, finding some merit in the arguments advanced in favor of diversification. Since only registered companies are actually precluded from diversification into non-functionally related businesses, minor modifications in the Act might be found appropriate. The solution, however, is certainly not repeal, or even drastic modification. Amendments should be fashioned which will permit diversification within limits and subject to SEC oversight. While we believe it unnecessary, the Congress might also wish to direct the SEC to undertake a rulemaking to define appropriate limits for diversification by the exempt companies.

Exhibit A

Public Utility Holding Company Act

Whereas a number of registered public utility holding companies have joined together in an effort to devise various amendments to the Public Utility Holding Company Act in the following respects:

1. Grant the Securities and Exchange Commission broad discretion to exempt from review the issuance of holding company securities or to repeal SEC's authority in this area entirely;

2. Permit holding companies to acquire nonutility businesses which are not functionally related to the utility business;

3. Reverse legislatively an administrative policy which requires service affiliates of holding companies to reduce their charges for services to operating subsidiaries of the holding company by any profits which they earn providing like services to entities outside of the holding company;

4. Eliminate the requirements that all service, sales or construction contracts performed by a subsidiary of a holding company or a mutual service company for any associate company must be performed at cost, permitting such services to be performed at fair market value; and

Whereas these proposed amendments are not consistent with the public interest, specifically:

1. Broader authority to exempt from SEC review the issuance of holding company securities is unnecessary since SEC has ample latitude to prejudge security issues and insure that companies may enter the market at the most advantageous time. Elimination of the SEC review authority, however, would deprive consumers of one of the basic protections of the Act.

2. Allowing holding companies to enter into non-related business could result in serious financial harm to the holding company and seriously impair its ability to carry out its electric service to their consumers. Incidental benefits to the holding company flowing from the sale of services outside the holding company systems should accrue directly to the electric utility consumers through lower rates.

4. Allowing affiliate companies to charge the fair market value rather than requiring that such transactions be cost based is contrary to one of the basic purposes underlying the passage of the Act. Congress was concerned aout abuses which had arisen from contracts between associated companies of the same holding company systems, and the cost standard was designed to compensate for the absence of arm's length bargaining, and

Whereas the suggested amendments, if enacted, might encourage the creation of new electric utility holding companies: Now, therefore, be it

Resolved That the American Public Power Association opposes any amendments to the Public Utility Holding Company Act except amendments, either previously identified or subsequently proposed, which clearly and demonstrably will operate to the benefit of the customers of the public utility holding companies.

Adopted by the membership of the American Public Power Association at the annual conference June 23, 1981, San Francisco, California.

EXHIBIT B

NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

1972

REPORT OF THE AD HOC COMMITTEE ON NON-UTILITY INVESTMENTS

INTRODUCTION

After approval by the Executive Committee in March 1971, NARUC President George I. Bloom appointed the Ad Hoc Committee on Non-Utility Investments to examine the trend toward diversification among regulated companies and to determine the effect of such diversification on public utility regulation. A progress report was submitted to the National Association of Regulatory Utility Commissioners at the annual meeting in September 1971.

The committee has met frequently, in New York City, Chicago, and Atlantic City. The initial meetings were devoted to outlining a procedure for securing necessary data and information. The later meetings were devoted to analyzing the material received by the Committee, outlining a report, and reviewing and revising the several report drafts.

As a part of the study extensive questionnaires were directed to State Commissions, industry groups and others whose viewpoints seemed likely to be helpful. In addressing ourselves to the industry trade associations we invited comments from individual companies and a substantial number were received. Separate inquiries were made of the major diversified natural gas pipelines. Inquiries were directed to two bond rating agencies and to various financial institutions. The responses of the bond rating agencies are attached as appendices.

The Committee sought also to secure the benefits of the information and viewpoints of the Federal Communications Commission (FCC), Securities and Exchange Commission (SEC), Federal Power Commission (FPC), and Interstate Commerce Commission (ICC). The Federal agencies were invited to send representatives to the meetings of the Committee. Aaron Levy, The Associate Director in the Division of Corporate Regulation, SEC, William White, Chief of the Domestic Rates Division, Accounting Section, Common Carrier Bureau, FCC, and Kelly Griffith, Chief of the Domestic Rates Division, Common Carrier Bureau, FCC, attended one or more meetings. Mr. Levy supplied extensive data for the Committee's consideration and some data were also received from the ICC and FCC. The Committee wishes to acknowledge its indebtedness to the individuals named and to the agencies for which they work for their participation and cooperation.

Harry Westcott, recently retired as Chairman of the North Carolina Public Service Commission, participated in the early stages of the preparation of the report and the Committee expresses its appreciation for his help.

The Committee acknowledges a special indebtedness to Everett L. Morris, former Director of Accounting and Tariff Analysis of the New York State Public Service Commission, who served as Secretary and who handled most of the staff burden, as well as contributing to the preparation of the report. The Committee also expresses its appreciation to Catherine D'Andrea, a member of the staff of the New York Public Service Commission, who performed much of the research work in compiling data on diversification. However, the Committee takes full responsibility for the report in form and substance.

The extensive files accumulated in the preparation of the report are available for examination at the offices of the New York State Public Service Commission in Albany.

This report is concerned solely with gas, electric, telephone and water utilities. Moreover, while the report discusses non-utility activities which are functionally related to utility operations, the main focus of the report is on functionally *unrelated* operations, and it is this type of "diversification" which is the principal subject of discussion.

The report considers:

The general phenomenon of diversification.

The nature of public utility financing.

The nature of the considered public utility industries, both generally and in particular.

The extent of diversification in the particular public utility industries.

An evaluation of the advantages and disadvantages of diversification by the considered public utilities.

The adequacy of existing regulatory controls over diversification by public utilities.

Finally, conclusions and recommendations are set forth.

The Committee, in studying this problem, also has reviewed the testimony in pending SEC proceedings concerned with problems of diversification, has reviewed testimony in Congressional hearings, and has considered the textual material and numerous articles dealing with the subject.

A final preliminary word. The Committee's perspective, naturally enough, has been that of the utility consumer and the regulation of utilities in the consumer's behalf. We have not attempted an appraisal of the problems of diversification from the perspective of management or investor, although we have considered the arguments made by management and investor interests as to the public benefits of diversification.

Respectfully submitted,

JOSEPH C. SWIDLER, New York, *Chairman*
ROBERT K. BLOOM, Pennsylvania
WILLIAM F. EICH, Wisconsin
RICHARD A. ELKIN, North Dakota
WILLIAM K. JONES, New York
THOMAS MORAN, California
ARCHIE SMITH, Rhode Island
WILLIS F. WARD, Michigan
FRANK S. WARNER, Utah

August 11, 1972

An analysis of available information on the results of the diversification of the pipeline industry does not disclose the extent of the profitability of the diversified activities of the pipelines. To arrive at valid conclusions is practically impossible without a detailed internal examination of each major company, since the pipelines do not freely disclose such information. Reporting requirements in effect during past years did not require sufficient breakdown by product or type of activity to enable investors and the general public to determine the profitability of different activities. The Federal Power Commission and the Securities and Exchange Commission may require more detailed reporting in the future. In addition, the accounting profession, in response to public pressures, is encouraging more informative reporting.

It does seem clear that pipelines have been able to enter diversified activities because of the financial base and support afforded by the basic pipeline activities. Higher revenues do not necessarily insure higher profits, but a pipeline operation generates a stable cash flow which can be used to even out the cyclical turns in non-utility businesses.

All diversified activities undertaken by pipelines have not been successful. For example, Bauer Dredging Company, owned by Texas Gas Transmission, had a loss of over $2 million in 1970. El Paso's textile division was chiefly responsible for El Paso's earnings decline in 1970. Colorado Interstate had profit declines in its petroleum division and in its Marsh Instrument Company in 1971.

There is little evidence to show that the customers of the natural gas pipeline companies have benefitted as a result of diversification activities of the pipelines with one possible exception. Southern Natural Gas, because of its highly successful Offshore Company, may have maintained credit equal or superior to what it could have maintained solely on its pipeline operations. To the extent that it has superior credit, if it does, the lower overall capital costs benefit its pipeline customers. A careful examination of Tenneco's operations, including the capital it has raised, the cost of its capital, and the profit contributed by its pipeline, tends to support the conclusion that its pipeline customers have not received any benefits as a result of Tenneco's diversification "successes".

To contribute to a balanced presentation on the difficult question of consumer benefit from diversifcation as it relates to pipelines, the entire responses of W. M. Elmer, Chairman of the Board of Texas Gas Transmission Corporation, and of Marvin Chandler, Chairman of the Executive Committee, Northern Illinois Gas Company, are attached as Appendix A and Appendix B, respectively. These are the most comprehensive and strongest arguments favoring utility diversification received by the Committee.

IV. EVALUATION OF DIVERSIFICATION BY PUBLIC UTILITIES

Evaluation of the wisdom of diversification by public utilities is a difficult and complex problem because: (a) diversification has many different aspects (see Section II); (b) the problem of public utility financing poses serious problems (see Section III); and (c) each of the public utility industries differs in important characteristics, in the extent of existing diversification, and in limitations on that diversification (see Section IV). Nonetheless, the following generalizations appear to be appropriate:

A. Utility Credit

The maintenance of assured public utility financing is of such critical importance that every effort should be made to sever public utility operations from non-public utilityoperations, particularly where the latter are substantial in scope. The maintenance of public utility credit, through the protection of the investment-revenue cycle, has been the dominant consideration behind the regulation of public utility securities by state and federal agencies and is a basis for regulatory surveillance of transactions between public utilities and their affiliates. The alternatives to protecting the investment-revenue cycle are threats of impairment of the utility's credit or inflation of the utility's rates or both. The threats posed by extensive utility diversification are neither new nor illusory. Indiscriminate diversification by public utilities was one of the factors underlying passage of the Public Utility Holding Company Act of 1935. It also was one of the causes of the recent Penn Central debacle (as well as some of the earliest tribulations of the New Haven Railroad).

The current emphasis in regulatory circles is on taking preventive measures, rather than waiting for a crisis before taking action. Regulatory officials would be justly subject to criticism if, with the Penn Central example before us, appropriate measures were not taken to protect the critical function of public utility financing from possible impairment resulting from uncontrolled diversification.

B. Earnings Growth

One argument frequently made in favor of diversification by public utilities is that, because of regulation and other factors, the rate of growth of profits from utility operations is circumscribed. Greater profit growth can be achieved from non-utility operations, the argument goes, and such growth makes the enterprise more attractive to investors, thereby reducing the cost of capital to the benefit of utility customers.

The argument is not persuasive. Even in the case of successful diversification, the available evidence–including an FPC study and communications from the rating agencies (see Appendix C)–suggests that diversification *increases*, rather than decreases, the cost of capital to the enterprise. The reason, quite simply, is that earnings from non-utility sources (growth or no growth) are considered riskier than earnings from utility sources. Thus, much more of a non-utility's new money must be obtained from stock rather than debt, with corresponding impact upon return. Appendix E presents an argument for adjusting a utility's equity to eliminate investments in non-utility activities. Appendix F contains some restraining comments on the proposal set forth in Appendix E. Although it is not appropriate to adopt a rigid rule on the treatment of non-utility investments, this is an important issue that must be dealt with if utility consumers are to be protected from excessive capital costs.

In any case, the whole argument proceeds from two critical assumptions: (1) that management will be able to select investments more promising than the utility operation in question, and (2) that management is capable of effectively operating the new businesses it acquires. While there are numerous examples of successful utility diversification, there are examples of failures as well:

Florida Gas Company lost several million dollars in modular housing and has millions more invested in the venture, the recovery of which appears doubtful.

Northern Illinois Gas Company lost $29 million gross on its fertilizer business.

Pacific Lighting lost substantial amounts in a central air conditioning plant venture, and has over $20 million unrecovered investment in this activity.

These examples are cited not to prove that diversification by utilities generally, or even by these particular utilities, has been unsuccessful. (We have indicated the contrary above.) However, the examples cited do indicate the risks involved, and there are several small utilities which appear to be supporting unsuccessful non-utility ventures with revenues from their utility operations in direct contravention of the premises underlying public utility financing. See Appendix D on the Elizabethtown Gas Company diversification.

The riskiness of diversification is further exemplified by non-utility experiences. In the case of conglomerates generally, there have been failures as well as successes. Diversification does not provide guaranteed returns, since success is dependent on both the skill of management and good or bad fortune attending various risky ventures.

In general, therefore, the public utility customer has everything to lose and little to gain by acceptance of this argument.

There is, however, a more limited argument that may have merit. In connection with the discussion of "diversification of risks" (page 40), it is pointed out that in the case of small utilities (independent telephone companies, water companies, small electric or gas companies) geographical diversification through specialized holding companies is a justifiable approach. By reducing risks, such diversification also should reduce the cost of capital. Furthermore, the accumulation of many small enterprises into specialized holding companies permits capital to be raised in larger quantities and at lower unit costs, and protects small operations from the adverse impact of temporary adversity. The severe impact of the June, 1972 floods accompanying the tropical storm "Agnes" upon small independent utilities, such as the Corning (N.Y.) Gas Company, illustrates the point. In the event of extensive system damage a territorially diversified system is better able to repair the damage and resume normal service. In most instances, the availability of a telephone holding company or a water holding company or a gas or electric holding company should suffice for the purpose of achieving georgraphical diversification, capital attracting units of appropriate size, and some measure of "financial strength". There may be rare instances in which a small utility can attract capital on an appropriate basis only by affiliation with a diversified firm. Exceptions should be considered for such cases if they are shown to exist.

At several points reference is made to specialized holding companies, particularly in connection with the independent telephone and water industries. We make clear that while we think specialized holding companies may have a role as a preferred means of dealing with problems not otherwise soluble, we intend no adverse view on the continued operation of independent companies outside the holding company framework where it is practicable to conduct such an independent operation. We think also that where holding company systems combine utility and unrelated non-utility activities, the utility financing function is protected to some degree if the utility functions and unrelated non-utility functions are segregated in separate companies or separate subsystems of holding companies. The protection is not complete but it is helpful, and regulatory efficacy probably is promoted in other ways by such a separation, even though problems will remain (e.g., possible commingling of utility and non-utility funds through intercompany loans and guarantees). It should be noted that leading holding companies in both the independent telephone industry and the water industry–General Telephone and Electronics and International Utilities, respectively–are organized substantially along such lines.

C. Diversification of Risks

It might be argued that, by providing for diversification of risks, the entry by public utilities into unrelated fields will enhance their access to capital markets and facilitate public utility financing. In limited contexts, the argument has merit. But stated this broadly it confuses the basis of public utility financing with business financing generally. The nature of the problem can best be explored by distinguishing among several different situations.

First, for large electric power companies and for the Bell System, diversification of risks is unnecessary. Both operations are integral to the successful functioning of our society and economy and both will survive as vital entities as long as our society and economy survives in anything like its present form. As previously discussed, neither is threatened by changes in demand, costs, competition or technology–despite the difficulties that will be encountered by both.

Second, for independent telephone companies, water companies, and small electric companies, there may be a need for protection against the risks associated with a particular locality. But this kind of protection can be achieved–along lines already exploited extensively–by the formation of holding companies encompassing telephone companies, or water companies, or electric companies, located in different parts of the country. Once protection is achieved against the uncertainties of social and economic activity in a particular region, and the risks of natural disasters, the situation becomes analogous to the first case. Considering trends in demand, costs, competition and technology–telephone, water and electric service will be required from the existing industry for the indefinite future. Once geographical diversification is achieved, no further diversification of risks appears to be necessary.

Third, the gas industry provides a wholly different situation. As previously indicated, the future of the gas industry is clouded by the limitations on conventional domestic gas reserves. Growth of the industry will be restricted, and a major shift in sources of supply will be required. Natural gas pipelines and local gas distributors are confronted with substantially larger risks than the other utilities under consideration. Does this provide a good case for diversification?

(a) The investor in a gas company may indeed benefit if the company diversifies. But the existence and extent of the benefit will depend on whether management is able to select investments more promising than the gas industry itself, and whether management is capable of effectively operating the new investments it acquires. Neither is a foregone conclusion, and indiscriminate diversification is not necessarily the best solution to an industry's problems. A number of unsuccessful diversification ventures are noted previously in this report.

(b) It is not clear that successful diversification, even if beneficial to the investor, will be helpful to the utility customer. The assumption appears to be that a successful diversified company, earning profits on non-utility operations, will pour those profits into an unprofitable utility operation. Stated this way, the whole idea is business and financial nonsense, and examples can be found in the history of the railroads, and more recently in the activities of Western Union, to support the proposition that businessmen are not anxious to support a losing operation whether or not they are making money on other operations. (Sufficient financial strength to weather limited or temporary reverses is a different matter, and is considered in other parts of this report.)

As the previous point makes apparent, the general thrust of "diversification of risks" is to protect the investor and not the utility customer. It is arguable that the major aim of public policy–regarding the customer as the principal beneficiary of regulation–should be to *prevent* "diversification of risks". Suppose the gas industry were informed: "You are not going to be permitted to diversify. Either you find a means of meeting your public service obligations or you will go bankrupt!" If the analysis in the previous point is valid, the customer ultimately is no worse off under bankruptcy than under the sustained neglect incident to a losing operation. Indeed, bankruptcy would more likely precipitate prompt public intervention if the service is considered to be socially necessary. At the same time, without the option to diversify, the motivation for the industry to succeed in meeting its public service obligations is strengthened. It is a good question whether the natural gas pipeline industry would be imposing curtailments of deliveries today if the pipelines had not been permitted to diversify, and if they had been aware at all times that their success depended on the delivery of gas and nothing else.

This is the heart of the matter. If a public utility engages in substantial diversification and is successful, the principal beneficiary is the stockholder and not the utility consumer. If diversification proves to be unsuccessful, the stockholder is injured and the risk is great that the utility customer will be injured as well. The stockholders of a utility may win or lose as the result of diversification, but the consumer bears the risks of failure without any commensurate participation in the benefits of success.

(c) Even in the special case of the gas industry, it is not clear that diversification of risks is in the public interest. However, this conclusion should not be read as precluding the combination of gas transmission and distribution companies with other entities engaged in supplying energy requirements in order more successfully to meet those requirements. Thus, the entry of gas transmission and distribution companies into areas of gas supply (LNG, SNG, exploration and development of new reserves) should be encouraged; this kind of activity is not prohibited by the Public Utility Holding Company Act. Moreover, the formation of "combination" gas and electric companies should not be prevented, nor should existing combination companies be required to separate the two functions.* The unitary nature of the energy problem is discussed on p. 26. Of course, the point made with respect to geographical diversification of small telephone, water, and electric companies applies to small gas companies as well.

D. Management and Skilled Personnel

Another argument frequently made in behalf of diversification by utilities is that only through diversification can top quality management (or other skilled personnel) be attracted and retained by utilities. Furthermore, managerial and other skills are to some degree transferable and utility operations may gain from insights derived from experience with non-utility operations. A counter-argument frequently made is that diversification dilutes managerial attention, and, to the extent management is concerned with non-utility operations, utility operations suffer. To some degree the arguments cancel one another out. However, there are a number of factors which are worth mentioning pertaining to various aspects of this debate.

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* In requiring such separation under the Public Utility Holding Company Act, the SEC sometimes prevents mergers of electric companies subject to its jurisdiction which would be desirable on other grounds, because the merging companies are not prepared to divest themselves of their gas properties as a condition to obtaining SEC approval of the merger. This policy may have had merit in a period of ample gas supply and unrestricted competition between gas and electric services, but it makes doubtful sense today.

First, it can hardly be argued that utility operations under contemporary conditions provide inadequate challenges for management. To provide our society with adequate supplies of electricty, gas, telecommunications and water will provide awesome challenges for utility managements in the years ahead.

Second, although it may be true that a conglomerate may appear more dynamic and glamorous than a public utility from the vantage point of some new management prospects, the point is largely irrelevant. It hardly profits the gas department of a diversified company to add a bright new man to its roster whose interests lie in the electronics area. If the gas department is intrinsically interesting, company recruiters ought to be able to get the point across during the recruitment process; and if it is not, staffing the gas department with men lured to the company by the attractions of the electronics program is not likely to be helpful in the long run.

Third, as discussed below, it is likely that most utility functions will become increasingly diversified within themselves. This, too, should add to the attractiveness of utility positions, as well as affording opportunities for cross-fertilization of ideas.

Finally, while there is no denying that a skill or insight or contact obtained in one departement may be beneficial elsewhere, for example, that the overseas activities of some diversified natural gas pipelines assisted them in implementing programs to import LNG, the benefits are haphazard at best. Considering the availability of consulting firms, opportunities for contacts among various professionals as well as among co-workers, and the internal diversification discussed below, there is serious question as to whether the game is worth the candle.

Here the counter-arguments about fragmentation of management attention become significant. Returning to the interstate gas transmission companies, may it not be that the possible gain from the operations of diversified activities was less than the gain that might have been realized if the pipeline managements had devoted their undivided attention to assuring adequate gas supplies?

There is another, and perhaps more subtle, aspect to the impact of diversification upon utility management. Because of tradition or necessity, utility managements have become deeply conscious of their service obligations. Despite inadequacies which have appeared from time to time, most utility managements place great emphasis upon the continued rendition of safe and adequate service. The same tradition is not evident in the operations of conglomerates generally, and it would be unsurprising and unfortunate if, as a result of diversification, utility managements were to become less sensitive to their service responsibilities.

The qualification noted in connection with financing applies here also. There may well be utilities so small that the attraction of competent management and skilled personnel would be exceedingly difficult, if not impossible. The most appropriate response, as noted above, is joinder with a specialized holding company, which would also afford the advantages of geographical diversification, financial strength, and appropriate size for raising capital.

E. *Economical Use of Resources*

The previous headings have considered two kinds of resources: capital, and managerial and other skilled personnel. But a utility obviously possesses other resources as well, including production facilities, distribution facilities, technological expertise, and research resources. As in the preceding examples, a means should be found to achieve economical use of a utility's resources. Two problems should be distinguished before reaching any general conclusions.

1. *Problem of size*. A utility may be too small to take advantage of economies in accounting, warehousing, procurement and the like. The most suitable answer, for the reasons given above, may be merger with a neighboring company, or a specialized holding company.

2. *Joint products, by-products, and complementary services.* The area of joint products, by-products, sources of supply, and complementary services is not one where complete and comprehensive guidelines can be provided. However, three factors are important in determining whether an activity is a suitable one for a utility to undertake:

(a) The activity should be functionally related to the utility activity. Thus, it would be appropriate for an electric company, under this criterion, to procure a source of fuel supply by mining coal and running a railroad from the mine to its generating station. It may even be justifiable for the electric company to sell some small amounts of coal to others, or to provide rail transportation for others, as an incident to providing fuel for itself. Justification for an electric company entering the coal or railroad businesses on a scale or in a way not functionally related to the primary business would need to stand on an entirely different footing.

The question raised in this report with respect to various types of diversification are not intended to reflect adversely upon functional integration of operations to achieve maximum economies. It is only when functions are wholly unrelated (or related in a way so tenuous that integrated ownership offers no advantages over separate ownership) that criticism is expressed. Indeed, in the areas involving functional relationships it is anticipated that diversification will (and should) tend to increase rather than decrease.

(b) The activity should not approach in size the utility operation. Thus a gas company legitimately may explore for new gas deposits in order to augment its supply. It also properly may sell liquid hydrocarbons extracted from the gas prior to its transmission. But the functional relation should not be carried to the point of using the search for gas as a springboard for establishing a general oil business or petrochemical business. The oil and the liquid hydrocarbons can be sold to be exploited by others without impairing the operations either of the company or the economy as a whole.

(c) The activity should not violate antitrust standards. For example, the FCC has concluded that telephone companies should be limited in their involvement in cable television and data transmission, for reasons that need not be elaborated here. In general, these considerations go beyond the scope of this study and will not be further pursued in this report (except the question of combination gas and electric companies).

3. *General Conclusions.*

Limited diversification, such as support functions or utility related activities, may be advantageous to the utility consumer and the utility investor. However, due to the unique role of utilities in society there is little justification for a utility entering vertically integrated activities on a large scale relative to its utility investment, functions, and responsibilities.

Montana Power Company's investment in coal reserves may be a good illustration for discussion purposes, without intending any fixed conclusions. Through a wholly-owned subsidiary the company has reserves of some one billion tons of low-sulphur coal. In addition to assuring Montana Power of long-term fuel supplies the coal subsidiary also sells coal to other buyers. There is at least the possibility that the coal business could surpass the utility business in size and importance to management.

Before such a situation develops, it would seem appropriate to consider whether it would not be better to spin off the coal business to the stockholders and have it operate as an independent entity rather than as a subsidiary of the utility. Montana Power claims that the net income from sale of coal to others indirectly supports the utility operation by allowing "the company to borrow money at more attractive interest rates than would otherwise be the case". As discussed in this report the risk associated with non-utility activities is different from that associated with utility activities and successful diversification does not necessarily mean lower costs.

F. Possibilities for the Future

The provision of energy is regarded increasingly as a unitary problem. Accordingly, the joinder of electric and gas distribution companies to afford greater flexibility in the use of limited gas supplies and electric capacity appears to be in the public interest. While competition between gas and electric supply has positive features, the reduction or elimination of such competition–in a time of a gas shortage and an even more general energy shortage–would not be entirely harmful, at least insofar as curtailment of promotion of the sale of gas and electricity is concerned. At the same time, unified control allows the combination company, after serving residential gas customers, to determine whether–in light of the needs of gas customers (residential and commercial, present and future), the needs of electric customers, and the problem of air pollution–its limited supplies of gas should be diverted to storage, utilized for electric generation, or utilized by various non-residential classes of gas customers. Furthermore, both gas and electric operations have a vital interest in developing and implementing processes for the gasification of coal, one of the nation's most pressing energy priorities, although the process of gasification for gas transmission and distribution may not be the same as the process to gasify coal for boiler fuel.

The provision of electricity is increasingly linked to environmental considerations. Thus, it would not be surprising to find power companies involved in solid waste disposal, in managing recreational facilities integrated with power sites (including cooling ponds and transmission rights of way), and in enterprises such as fisheries making productive use of thermal discharges to waterways. Such involvements probably should be limited to pilot operations, and in any case ancillary activities should not achieve such dimensions that the tail wags the dog.

In other industries as well–particularly gas supply and telecommunications–it is anticipated that the provision of utility services will involve changing industrial configurations to meet new conditions of supply, demand and technology. Within the guidelines indicated above, it is anticipated that the industries will adapt with requisite flexibility and ingenuity.

Reference already has been made to the relation between real estate developments and new water companies. The problems associated with this form of diversification can be handled by the regulatory commissions without undue difficulty and do not require special consideration.

G. The Special Situation of Publicly Supported Housing.

One form of diversification that requires special consideration is public utility involvement in urban redevelopment, particularly ownership and operation of low and middle income housing. The critical shortage of low and moderate income housing coupled with the lack of sponsors to build the needed housing creates an opportunity for socially conscious enterprises. The social need for such housing must be considered in determining to what extent utilities should contribute to ease the shortage. The common good achieved for the community and utility in revitalizing the towns and cities where the utilities function make them logical candidates for the task. Some utilities have proceeded with such ventures with local regulatory approval, and federal and local housing agencies favor such involvement. The SEC has rules that public utility holding companies and their subsidiaries may not engage in this type of diversified activity, but since the SEC decision rested on an interpretation of the Public Utility Holding Company Act it should not be taken as an evaluation of the merits of the issue.

The two arguments for utility involvement, aside from the public interest that more housing be constructed for low and middle income families, are:

(1) Public utilities, because of the limitations of their franchises and the immobility of their invested capital, have a unique interest in the quality of the areas they serve. If the area deteriorates, the market for the utility's services will likewise deteriorate.

(2) Because of tax advantages associated with publicly supported low and middle income housing, the profitability of the ventures is assured and there is little risk of burdening the utility's customers with losses incident to the housing ventures.

These arguments have merit; however, there are significant countervailing considerations:

(1) While there undoubtedly is a need for more housing, there is no reason for believing that public utilities are uniquely qualified to fulfill this need. Organizational ability is not enough. The problems of operating managements are even more difficult. Most housing experts agree that resolution of the housing problem requires, not merely the construction of new units, but also skilled operation and maintenance of those units, a particularly difficult task and one that may require the sponsor's involvement over a prolonged period.

(2) Public utilities have an interest in the areas they serve, both from the vantage point of social responsibility and financial involvement. It is natural and desirable that utilities should wish to help in avoiding the deterioration of important parts of their service areas because of decaying housing and worsening slum conditions. Nevertheless their interest in new housing must be considered in light of their overriding obligation to provide adequate utility services at reasonable rates. Performing that function properly is a significant social contribution. In the typical case, there is no real prospect that the demand for utility services will be appreciably impaired if the utility fails to become involved in providing new housing. As previously noted, the main problem is the utility's ability to meet demands made upon it. Where the housing problem constitutes a genuine threat to the economics of utility supply, the case for participation is stronger.

(3) The profitability of participation in housing projects depends to some extent on the fleetness with which the utility escapes from the ventures. A rapid exit, once the project is constructed, will assure profitability, but is this

an adequate discharge of the utility's social responsibility upon which its entry into the housing field was justified? Continued involvement in the housing venture may manifest greater social responsibility, and contribute more to the ultimate success of the housing venture, but such immersion in housing problems creates risks of diminished profitability, may produce abrasive relations with tenants in utility operated buildings, and may distract utility management from its primary function of providing utility services. All of these can have detrimental effects upon utility operations.

There is the further problem that utility involvement in housing may result in undue preference for the utility's services in the housing constructed (e.g., all-electric homes in the case of housing built by an electric company) which is not necessarily consistent with a desirable allocation of resources or minimum charges to the housing project's tenants.

All things considered, utilities would be well advised to proceed cautiously in venturing into the housing field. Utility involvement in low and middle income housing should not be prohibited, in our view, but the following guidelines are suggested:

(a) Given the magnitude of the utility's primary responsibility for providing utility services, the utility should become involved in housing enterprises only to the extent that other capable housing project sponsors are unavailable.

(b) For the same reason, the utility should limit its involvement as much as possible. A consulting role is preferable to sponsorship. Construction and subsequent disposition is preferable to continue operation and maintenance, assuming adequate arrangements can be made for operation and maintenance by others.

(c) In order to avoid misunderstanding, the utility's role should be spelled out clearly in advance. If the utility is to construct a project and then sell it to an operator, the plan should be formulated in detail and express concurrence should be obtained from all interested parties, including local governments and community groups. To sell a project upon completion may create great hostility unless such a sale has been a part of the initial understanding.

(d) In no case should a utility undertake a venture for which it lacks adequate managerial capability (or which would impair its capital resources). There may be a shortage of housing, but there is no shortage of badly constructed and badly managed housing projects. The utility's capability should be carefully assessed before any commitment is made.

There are both positive and negative aspects involved in this question. It would be appealing to emphasize the positive only. However, experience to date has indicated that the negative aspects are substantial. Problems of adverse community relations have arisen as a result of utility involvement in housing ventures; lack of utility expertise in housing has manifested itself; and the installation of utility services in utility-sponsored housing has usually followed the self-interest of the utilities, which is not necessarily coincident with the best interests of the tenants or of society.

One final note of caution should be added. Just as the utilities lack expertise in housing matters, so do the commissions that regulate them. It is not likely to enhance the effectiveness of public utility regulation to have regulatory commissions involved in such questions as whether housing rentals are reasonable, whether housing services are adequate, whether the utility has unfairly exploited its position in establishing the energy arrangements, or whether a sale of a housing project by a utility to another party is in the public interest.

H. *Impact of Diversification on Effectiveness of Regulation*

Diversification poses several problems for regulation. One which is frequently mentioned is the difficulty of allocating costs between regulated and unregulated activities for the purpose of determining the proper costs of the regulated activity. This point has only minimal validity in the context under consideration.

Even where unregulated activities, such as fuel supply and the disposition of by-products, are closely related to the utility function, cost allocation problems are likely to be significant. Nevertheless, we have concluded that for economic and social reasons the operation of utilities in related fields of endeavor is not only desirable but probably unavoidable. The real questions center around utility involvement in unrelated ventures. Almost by definition, the problems of cost allocation, except for top management, are likely to be minimal under these circumstances. One area where diversification undoubtedly will complicate regulation is in cost of capital computations. The difficulties presented are reflected in Appendices E and F.

A somewhat more subtle problem, but one with more serious implications, involves the relationship between the regulated company and the regulatory commission representing the public. In the absence of diversification, the relation is one of mutual dependency. The regulated company needs the support of the commission (and the public) to obtain the revenues it requires to continue to provide adequate service. The commission (and the public), for their part, recognize that unless such revenues are forthcoming service is likely to be impaired.

The situation changes drastically, however, when the regulated company achieves significant diversification. The company is no longer dependent solely on the commission (and the public) for its revenues and may choose to render less than adequate service. A utility, in deciding whether to increase its investment, makes the calculation whether or not it is desirable to augment its utility operations. A conglomerate must decide which among its numerous operations would provide the greatest return on increased investment assuming a limitation on available funds. On the other side, the commission (and the public) may be moved to irresponsible decisions on the premise that, if the company fails to derive adequate revenues from the regulated service, it can always fall back on its unregulated revenues. Neither result is inevitable, and significant diversification has occurred without impairment of the regulatory process, but all parties should be alert to the risks.

V. EFFECTIVENESS OF CONTROLS OVER DIVERSIFICATION BY PUBLIC UTILITIES

There is a need to strengthen controls over public utility diversification at both the state and federal levels.

At the federal level, the Public Utility Holding Company Act is adequate in the areas of electric power and local gas distribution, and the Western Electric Consent Decree limits diversification by the Bell System.

There is no federal control over either telephone holding companies or water holding companies, and neither can be effectively controlled by the states. It would seem desirable to subject such holding companies to federal regulation. Given its experience under the Public Utility Holding Company Act, the SEC would appear to be the most likely candidate although, in the case of telephone holding companies, the FCC also should be considered. However, the standards for telephone and water holding companies should not be the same as those applicable to gas and electric holding companies. This would permit water company affiliation with real estate developers and telephone company affiliation with equipment manufacturing and procurement operations, in the absence of specific public policies to the contrary. In particular, geographical diversification of water and telephone companies should not be discouraged. Otherwise, the approach of the SEC under the Public Utility Holding Company Act–limiting utility enterprises to utility services and functionally related operations–appears to be appropriate.

The diversification of interstate natural gas pipelines should be carefully scrutinized by the FPC, which recently has instituted a proceeding to obtain information on this matter. Whether it is too late for the Congress and the FPC to take meaningful action in this area is an open question.

On the state level, existing controls are for the most part inadequate, even though most states have authority to control the disposition of proceeds from the issuance of public utility securities. Few states have explicit authority to regulate the reinvested earnings of public utilities from their utility operations, and even fewer have explicit authority to regulate reinvested earnings derived from non-utility operations. (In some cases, states claim indirect authority over reinvested earnings despite the absence of explicit statutory authorization.) What this means is that while a utility in most states would require state regulatory approval if it sought to diversify by using the proceeds of a security issue for the purpose, in the typical situation where reinvested earnings were employed, no such approval would be required in most states, and in even fewer instances would approval be required if a diversified utility employed earnings from its non-jurisdictional activites.

In the case of mergers and affiliations, the pattern of controls is similarly incomplete. In many states, commissions have authority to control mergers or affiliations involving utility and non-utility enterprises. Once the merger or affiliation is consummated, however, further control by the state commission is problematical. As previously indicated, state commissions cannot practicably regulate multi-state water or telephone holding companies. Other affiliations between utility and non-utility corporations (such as a non-utility subsidiary of a utility corporation) may be subject to state control in a theoretical sense, but it is questionable whether in most instances state commission control is authorized by statute or is actually exercised. In the case of a completed merger of regulated and unregulated enterprises, the state commission faces the problem, noted above, of lack of control over the earnings of the unregulated activity–which may be employed for further diversification. A table showing existing regulatory control over non-utility diversification by state is attached as Appendix G.

The result of the present pattern of state controls is that, while many state commissions may have authority to preclude diversification by merger or affiliation in the first instance, once some measure of diversification is achieved, the process passes beyond regulatory control in most instances and further diversification can be achieved without regulatory approval. Remedying the errors of the past is even less likely. Little attention has been given to the wisdom or feasibility of requiring the separation of presently diversified public utility entities, an area in which the SEC achieved considerable success under the Public Utility Holding Company Act.

VI. CONCLUSIONS AND RECOMMENDATIONS

In view of the considerations discussed above, the Ad Hoc Committee submits the following conclusions and recommendations:

A. *State Commission Control*

State commissions should seek (if they do not already possess) adequate authority to control diversification by gas, electric, telephone and water companies subject to their jurisdiction. Such authority should include:

1. Control over the disposition of proceeds of securities issues of public utilities.
2. Control over the investment of utility funds in non-utility enterprises, without regard to whether the funds are derived from utility or non-utility operations.
3. Control over the merger or affiliation of public utilities with non-utility enterprises.

4. With respect to enterprises affiliated with local utilities and which do not operate utilities in other states, control over the further investments of such affiliates.

5. Power to order the severance of non-utility from utility operations when it is in the public interest to do so.

B. *Federal Control*

In situations where state commission control is impractical, diversification by gas, electric, telephone and water utilities should be controlled by appropriate federal agencies. Specifically:

1. Electric power companies and local gas distribution companies should continue to be subject to the Public Utility Holding Company Act where they are components of public utility holding company systems. The exemptions of presently exempt holding companies should be reexamined and, if necessary to prevent improper diversification, such exemptions should be revoked.

2. Water holding companies and telephone holding companies should be brought within the ambit of the Public Utility Holding Company Act under revised standards recognizing the special requirements of such industries, including the need for geographical diversification. In the case of telephone holding companies, the FCC may be a more appropriate regulatory agency than the SEC.

3. The Federal Power Commission should scrutinize diversification by interstate natural gas pipelines to determine whether such diversification is in the public interest, and seek additional legislation, if required, to control such diversification.

C. *Applicable Standards*

While recognizing that each case must be decided in light of the particular facts pertaining to the utility and non-utility operations in question, the following should be employed as general guidelines.

1. Utilities should be permitted to engage in non-utility operations where the latter:

(a) Are functionally related to the utility operation (e.g., sources of supply, joint products, complementary operations); and

(b) Are not overly large in relation to the utility operation; and

(c) Are within the utility's financial and managerial resources; and

(d) Do not violate antitrust laws or other public policies.

2. In addition, utilities should be permitted to participate in governmentally supported low and middle income housing projects where:

(a) No other qualified participants are available and interested; and

(b) The role of the utility in the project is clearly defined; and

(c) The utility has the managerial and other resources to fulfill that role, as well as the support of local governments and community groups.

3. With few exceptions, utilities should not be permitted to engage in non-utility activities. Exceptions may be warranted in particular cases where:

(a) A utility of small size has no alternative to affiliation with a non-utility in order to obtain access to capital, qualified personnel or other needed resources; or

(b) Other special circumstances justify limited investments by public utilities in unrelated non-utility ventures, but such investments should not exceed 5 percent of the company's utility investment and the venture should not be one of high potential losses, so that the non-utility investment and operating lossess will not be so large as to impair the company's credit if the venture is unsuccessful. Adjustments to the capitalization, as discussed in Appendices E and F, may be appropriate to protect the utility consumers from excessive capital costs.

4. Restrictions against combination gas and electric operations, presently effected by the SEC's policies under the Public Utility Holding Company Act, should be reconsidered in light of the gas shortage and the desirability of coordinating various energy operations.

5. If holding company systems are to be permitted to retain both utility and (unrelated) non-utility properties, the two types of activity should be segregated in different companies or in different holding company subsystems.

D. *Further Study*

The problems encompassed by this report are complex and are subject to the influences of changing events. It is recommended that the subject be reexamined by a NARUC Committee within five years.

EXHIBIT C

State of Wisconsin \ PUBLIC SERVICE COMMISSION

March 12, 1982

STANLEY YORK, CHAIRMAN
WILLIE J. NUNNERY, COMMISSIONER
BRANKO TERZIC, COMMISSIONER
4802 SHEBOYGAN AVENUE
P.O. BOX 7854
MADISON, WISCONSIN 53707
(608) 266-2001

The Honorable John S. R. Shad, Chairman
Securities and Exchange Commission
Washington, D.C. 20549

File No.

Dear Chairman Shad:

State regulators are concerned with the Securities and Exchange Commission's December 21 proposal to Congress that the Public Utility Holding Company Act of 1935 be repealed. At its regular winter meeting in Washington, the Executive Committee of the National Association of Regulatory Utility Commissioners passed a resolution which "requests that the United States Securities and Exchange Commission reconsider its position and that further the Congress refrain from enacting any changes in the Public Utility Holding Company Act of 1935 until State regulators have received and considered the report of the Ad Hoc Committee on Utility Diversification no later than July 1, 1982."

I am the chairman of the NARUC Ad Hoc Committee on Utility Diversification. Our committee consists of ten regulatory commissioners from nine different states. We will vigorously oppose any Congressional actions on PUHCA which do not allow for adequate input from state regulators. Once our study is completed, I expect that the committee will take a firm position on the need for the Act. This position will be communicated to all state commissions.

We will be holding hearings on the question of utility diversification in Madison, May 6 and 7. Utilities, law firms, consultants, trade associations, public counsels, citizen groups, intervenors and others are expected to present testimony on utility diversification and holding companies.

The full text of the resolution is enclosed. I will keep you apprised of future developments.

Sincerely,

Stanley York

Stanley York
Chairman

SY:GBE:dw

Enclosure

cc: The Honorable Richard Ottinger, Member of Congress
The Honorable Edward Burke, NARUC President
The Honorable Paul Rodgers, NARUC General Counsel
Members, Ad Hoc Committee on Utility Diversification

EXECUTIVE COMMITTEE RESOLUTION CONCERNING CONGRESSIONAL ACTION WITH RESPECT TO THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

WHEREAS, the United States Securities and Exchange Commission has unanimously recommended to the Congress that the Public Utility Holding Company Act of 1935 (PUHCA) be repealed; and

WHEREAS, members of the Congress have introduced legislation to substantially modify or repeal the Act; and

WHEREAS, many state public utility regulatory commissions rely on provisions in the Act to assist in the effective regulation of electric and gas utilities within their jurisdictions; and

WHEREAS, the contemplated changes in the Act may seriously jeopardize the ability of state commissions to regulate these utilities; and

WHEREAS, the National Association of Regulatory Utility Commissioners has appointed a special Committee of state regulators to investigate the issue of utility diversification; and

WHEREAS, this Ad Hoc Committee on Utility Diversification will explicitly consider the importance of the Public Utility Holding Company Act to effective state regulation and expects to report by summer 1982; now therefore, be it

RESOLVED, that the Executive Committee acting on behalf of the National Association of Regulatory Utility Commissioners respectfully requests that the United States Securities and Exchange Commission reconsider its position and

(MORE)

that further the Congress refrain from enacting any changes in the Public Utility Holding Company Act of 1935, until State regulators have received and considered the report of the Ad Hoc Committee on Utility Diversification, no later than July 1, 1982.

# # #

Founded in 1889, the NARUC is a quasi-governmental, nonprofit organization whose members include regulatory bodies of the 50 States, the District of Columbia, Puerto Rico, Guam, and the Virgin Islands. Designed to serve the public interest by seeking to improve the quality and effectiveness of government regulation of carriers and utilities, its members play a crucial role in shaping the profile and substance of public regulation in America today.

EXHIBIT D*

U. S. Department of Energy
Federal Energy Regulatory Commission

Automatic Adjustment Clauses in Public Utility Rate Schedules

February 1982

A Staff Report on the
Implementation of Section 208
of the Public Utility Regulatory
Policies Act of 1978

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* Consists of pages 68-72, 187-199 of this staff report.

identified with utilities having captive coal operations, that is, coal supply operations in affiliate companies. [9]

Captive coal is rapidly increasing in importance as a source of fuel for the electric utilities. In 1965, 13 million tons or about 6 percent of all coal used by electric utilities came from captive mines (Table VI-6). In 1978, captive coal deliveries totaled 67 million tons, or 14 percent of total coal deliveries to the electric utilities. Captive coal production is projected to reach 143 million tons by 1985, when it will account for 20 percent of the projected 1985 total utility coal consumption of 733 million tons.

Table VI-6

The Role of Captive Coal in Total Coal Deliveries to Electric Utilities

	1965	1978	1985 (Projected)
Total Coal Deliveries To Electric Utilities, (million tons)	243.6 a/	476.2 b/	733.1 c/
East of Miss. River	N.A.	334.7	433.2
West of Miss. River	N.A.	141.5	299.9
Captive Coal Deliveries, (million tons)	13.4 a/	66.8 b/	143.2 b/
East of Miss. River	N.A.	29.5	45.7
West of Miss. River	N.A.	37.3	97.5
Ratio of Captive to Total, %	5.5	14.0	19.5
East of Miss. River	N.A.	8.8	10.5
West of Miss. River	N.A.	26.4	32.5

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a/ Source: National Coal Association, Coal Facts 1974-1975.

b/ Source: Federal Power Commission, Electric Utilities Captive Coal Operations, June 1977, and update of the statistical information in the report through June 1979.

c/ Source: National Electric Reliability Council, 1980 Summary of Projected Peak Demand, Generating Capability, and Fossil Fuel Requirements for the Regional Reliability Councils of NERC, July 1980.

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[9] Captive coal includes outright ownership and operation of the coal mining facility by an electric utility, or utility ownership of the coal reserves with an arrangement with an independent mining company to mine the coal, or as in a few cases in which the utility has a financial arrangement with a coal mining company such that something other than an arms-length transaction is involved.

The preliminary findings are that: (1) captive coal prices are, on the average, significantly higher than comparable non-captive coal prices; (2) captive coal mines appear to be operating less efficiently than comparable noncaptive coal mines; and (3) regulation of electric utility affiliated coal operations may be inadequate to assure the efficient management of captive mines and the reasonableness of the captive coal prices.

Captive vs. Non-Captive Coal Prices

In 1978, captive coal prices for utilities located east of the Mississippi River averaged 140.5 cents per million Btu (FOB utility) compared to 122.3 cents per million Btu for comparable non-captive coal. The finding that captive coal prices are generally higher than non-captive coal prices agrees with the findings of earlier Commission studies on captive coal. 10/ Additional discussion of captive coal prices is given in Appendix B.

In 1978 the electric utility industry operated 110 coal mines nationwide. Staff analysis of the 73 captive coal mines located east of the Mississippi River resulted in the conclusion that these 73 captive mines (64 of which produced coal in 1979) were being operated much less efficiently than comparable non-captive coal mines. (The measure of efficiency used in this comparison was a productivity index of tons per man-day.) Analysis showed that the 64 captive mines had an average productivity index of 11.6 tons per man-day, significantly lower than the 16.6 tons per man-day average productivity index for the comparable non-captive mines. 11/

Regulation

The authority to regulate the transfer price of the captive coal used by electric utilities is divided among State Public Utility Commissions and two Federal agencies, the Federal Energy Regulatory Commission (FERC) and the Securities and Exchange Commission (SEC).

The State Public Utility Commissions have jurisdiction over all intrastate retail sales of electricity (approximately 90 percent of total revenues from electricity sales of privately owned utilities in the U.S.). Many of the State PUC's have limited

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10/ Federal Power Commission, *Electric Utilities' Captive Coal Operations*, June 1977. The statistical information in the report has been updated through June 1979 by the Federal Energy Regulatory Commission Staff. ✓

11/ See U.S. Department of Energy, *Coal Competition: Prospects for the 1980's*, Draft Report, January 1981, Chapter VIII.

resources with which to regulate affiliate coal operation effectively. The Federal Energy Regulatory Commission has jurisdiction over wholesale and interstate sales of electricity. This jurisdiction includes authority to determine in rate cases the reasonableness of captive coal prices. The SEC has the authority to regulate holding companies and their affiliate operations to protect the investors in these companies. 12/ At this time the SEC has a limited involvement in regulating captive coal since only 13 utilities of the 39 utilities involved in captive coal in 1978 are members of holding companies (however, these 13 utilities used almost 50 percent of all the captive coal produced in 1978).

The relevant FERC regulation is Section 35.14, paragraph 7 of the Code of Federal Regulations which states:

> "... Where the utility purchases fuel from a company-owned or controlled source, the price of which is subject to the jurisdiction of a regulatory body, such cost shall be deemed to be reasonable and includable in the adjustment clause ..."

The staff review indicates that deferral to another regulatory body, as provided in Section 35.14, may not provide adequate assurance of reasonable rates and may not alert the Commission to situations involving unreasonable rates. An earlier staff review of State commission regulations of affiliated fuel operations indicated that the extent and effectiveness of these regulations vary widely among the states. 13/

The major growth in captive coal will be for utilities west of the Mississippi River. In 1978 the Western utilities used 37 million tons, or 55 percent, of the total 67 million tons of captive coal. By 1985, utilities located in the West are projected to use 98 million tons, or about 68 percent, of the projected total captive coal production of 143 million tons.

The increasing use of captive coal by the electric utility industry is due both to expansion of captive operations by utilities that presently use captive coal, as well as to additional utilities acquiring interests in coal reserves and production. In December 1975, the utilities controlled 11.6 billion tons of recoverable coal reserves; by June 1979, the total had reached 13.5 billion tons. Most of the increase in utility coal reserve holdings has been in the Western coal regions. In 1975, 66 percent of utility-owned recoverable coal reserves were located in the West; by 1979, 70 percent of the total was in the West.

12/ This authority was given to the SEC under the Public Utilities Holding Company Act of 1935.

13/ A study on Electric Utility Associate Fuel Companies (State Regulatory Oversight) was prepared for the FERC in September 1980. A summary of that study is included in Appendix B.

Chapter VII

Conclusions

Use of Automatic Adjustments

The great majority of rate schedules for wholesale electric service provide for automatic adjustment of rates based on changes in cost, either in the form of a limited specific adjustment, as with a fuel adjustment clause, or in the form of rates that are partly adjustable on the basis of incremental energy cost or fully adjustable on the basis of all costs, the latter usually applying to service from a specific facility. For transactions among large privately-owned utilities, incremental energy cost rates (IECR's) predominate, and rate schedules of this type constitute, by far, the largest group among the types on file at the Commission. Rates based on comprehensive costs of service (CCFR's), while much fewer in number, are widely used in situations where utilities seek to share certain risks of ownership of facilities without joint ownership.

Rate schedules containing fuel adjustment clauses (FAC's) predominate (77%) in full or partial requirements service provided by privately-owned utilities to smaller utilities such as municipally-owned or cooperatively-owned utilities and small privately-owned utilities.

Incentive Effects

The Commission Staff review provided no direct indication that the presence of automatic adjustments leads to utility actions that are adverse to the efficient use of resources. Qualitative analysis of incentive effects provides a basis for the conjecture that AAC's may reduce utility management incentives toward efficiency. It would not be possible to say, based on this analysis, that, in the words of Section 208, ". . . each such clause effectively provides incentives for efficient use of resources. . . " But quantitative evaluation, including a statistical analysis of FAC features and utility costs, does not show a measurable effect attributable to the absence or weakening of these incentives in the utilities' wholesale business. [1]

Variability and Predictability

The material in Chapter V demonstrates that fuel costs are generally subject to periodic fluctuations and are not susceptible to precise determination in rate cases prior to the time such costs are incurred. The use of FAC's in wholesale rate schedules appears to be an effective means of reflecting variable costs of service in rates, of maintaining a desirable stability in utilities' recovery of incurred costs, and of avoiding an unproductive increase in rate case proceedings.

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[1] As noted in Chapter IV, statistical analysis of retail clauses alone indicates a small effect in the form of a fuel input distortion associated with use of an FAC. The distortion indicated amounts to an approximately 0.3% increase in total production cost for a 10% increase in cost recoverability resulting from more liberal clause features.

The two types of fully adjustable rates, IECR's and CCFR's, are structured to reflect certain costs that, while variable, are relatively predictable. The primary purpose of these rates, however, is to provide an equitable basis for types of inter-utility transactions that appear desirable to encourage: in the case of IECR's, the transactions tend to facilitate operation of interconnected systems at minimum total cost; in the case of CCFR's, the transactions tend to encourage coordination of plans for increases in capacity.

Utility Practices

The staff review disclosed a number of practices related to fuel procurement that appear to reflect a degree of utility management laxity with respect to minimizing delivered cost of fuel. There is not, however, any indication that the prevalence of such practices is related to the presence of FAC's in a given utility's wholesale rate schedules.

Statistical Analysis of Captive vs. Non-captive Coal Prices

It was determined that to make a valid comparison of captive and non-captive coal prices the analysis should be conducted at the regional coal market level rather than at the national level. That is, a utility and its captive coal prices were compared to the non-captive coal prices found in the regional coal market in which the individual utility does business. 15/ The major benefit of using regional price comparisons is that the regional coal markets vary appreciably in their coal supply and demand conditions, and this approach will compare only prices affected by and resulting from similar market conditions. The delineation of regional coal markets is discussed earlier in this Appendix; the result is shown on the map on page 13.

In addition to aggregating the coal price data by regional coal market a second criterion was established that only long-term contract coal prices would be used for the non-captive prices. This criterion was established because these contracts fulfill basically the same role as captive coal of giving the utility a long-term committed supply of coal.

The source of the coal price data used in the analysis was the individual utility responses to Commission staff requests for information on coal contract prices as part of the investigation in Docket IN79-6. The coal price data from FERC was for calendar year 1978.

After analyzing the coal price data as it had been aggregated by regional coal markets, the conclusion was drawn that a valid statistical analysis of captive and non-captive coal prices could be conducted only with the data from Coal Market Region 1 (Eastern). This conclusion was based both on the quantity and quality of the data and the nature of the individual coal regions. Coal Market Regions 3 and 4 were not considered suitable for statistical analysis because both areas, being relatively small coal users, did not have enough captive and non-captive coal price records to make a valid comparison. Coal Market Region 2 was not considered suitable for analysis because inclusion of transportation costs in the coal price data would heavily bias the analysis in favor of the captive mines. Most of the captive mines in Region 2 are mine-mouth operations and would have minimal transportation costs included in their coal prices. In contrast, a large portion of the non-captive coal traded in Region 2 travels long distances from mine to power plant and has large transportation costs which would significantly increase the FOB plant price of the non-captive coal.

15/ See footnote 9 on page 165.

In an analysis of coal prices in Coal Market Region 1 the problem of having transportation costs included in the coal prices becomes much less significant than is the case in Region 2. The coal fields run throughout much of Region 1 with the mines generally much closer to the power plants; consequently, transportation costs are a smaller part of Region 1 FOB plant prices. Furthermore, the effect of using FOB plant prices in the analysis would probably slightly favor the captive coal prices since many of the captive utilities are located within the coal producing areas and would have transportation costs lower than the regional average.

In addition to having the transportation costs included in the coal prices there are other factors which may bias the comparison either in favor of the captive or non-captive prices. The most important factors are:

(1) Ideally each captive coal contract should be compared only to non-captive coal contracts signed during the same period of time since newer contracts would usually have higher prices due to the increasing costs of opening new mines. However, the contract start-up date was not known at the time of the analysis and therefore the captive coal prices were compared to all non-captive coal prices. Since the time the analysis was conducted, additional information became available which shows that the average start-up date for the captive contracts was 1967 while the average for the non-captive contracts was 1975. 16/ Based on these average contract start-up dates it would appear that the analysis would have a downward bias in favor of the captive coal prices.

(2) The individual contract data was not identified by method of mining operation used to extract the coal (strip or underground mining) and therefore the analysis could not be separated by method of mining. In general, strip mines are less expensive to operate and should have lower prices than underground mines. Consequently, if captive or non-captive coal is disproportionately mined by strip or underground methods, the group which is more heavily produced from strip mines will probably have a downward bias on its average prices. Computations

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16/ It would appear that captive coal contracts being, on the average, of older vintage than non-captive contracts is logically inconsistent with the fact that captive coal production is increasing faster than non-captive production. However this is not the case here since this analysis is limited to captive utilities located in the East and, as can be seen from Table VI-6, most of the growth in captive coal is in the West with relatively small additional development by Eastern captive utilities.

made from other data sources 17/ indicate that 30 percent of the captive coal was strip-mined while 65 percent of the non-captive coal was strip-mined. Based on these percentages it appears that there would be a downward bias in favor of the non-captive coal prices.

Results of the Comparison of Captive vs. Non-Captive Coal Prices

The comparison of captive and non-captive coal prices from Coal Market Region 1 was made using the statistical testing method called the "t-test".

The data on captive and non-captive coal prices was aggregated by utility so that there was one weighted-average price per utility for all of that utility's non-captive coal purchases, and, if that utility also bought captive coal it would have a second weighted-average price for its captive coal. As a result of these utility-by-utility aggregations the data base used in the t-test consisted of 53 non-captive coal prices and 16 captive coal prices.

The results of the statistical analysis, given below, show that captive coal prices were significantly higher than non-captive coal prices.

Captive Coal Prices	Non-Captive Coal Prices	Level of Significance
140.5	122.3	.907

Summary of Report on State Regulatory Oversight of Electric Utility Associate Fuel Companies

This section summarizes a study 18/ on the degree of State Public Utility Commissions (PUC) regulation of transactions between electric utilities and their affiliates involved in any phase of fuel supply. The study was based upon the results of a PUC survey on such oversight. Three basic questions were addressed in the survey:

17/ The 1978 captive coal strip vs. underground mining ratio was calculated from the data base created to analyze the technological efficiency of captive mines reported in Chapter VIII of Coal Competition: Prospects for the 1980's, U.S. Department of Energy Draft Report, January 1981.

18/ "Study of Electric Utility Associate Fuel Companies (State Regulatory Oversight)," prepared by Sheldon L. Bierman pursuant to Purchase Order No. DE-AP39 80RC10248.00, September 1980.

(1) Have Commissions developed structured policies and programs regarding utility-fuel affiliate relationships?

(2) What regulatory approach do Commissions use?

(3) What issues do the Commissions emphasize in regulation?

Thirty-six states in the contiguous United States have jurisdictional utilities with fuel affiliates and the survey responses from these states indicate wide variations in regulatory efforts.

Results

Since transactions between a utility and its affiliate fuel company do not usually result from a process of arms-length bargaining by independent parties, each seeking to obtain the most advantageous arrangement for itself, the possibility exists that affiliate profits may exceed reasonable levels, or that subsidiary operations may be technically inefficient, and consequently, utilities will be burdened with excessively high fuel prices.

In each area addressed in this survey, in initial regulatory policy development, in regulatory approach, and in the emphasis of regulation, the efforts of State PUC's appear to be limited. Most factors that were examined in the survey were not considered by about one half to more than two-thirds of the 36 Commissions. In some states, Commissions appear to lack the authority to deal with affiliates. Many PUC's also lack the resources necessary to undertake the additional responsibilities of thorough investigations. Inadequate reporting and recording requirements and the resulting lack of systematic information contribute to regulatory problems.

State-by-State Survey

The survey requested data on whether or not PUC's have policies or programs to regulate the transactions between utilities and their fuel affiliates. While 19 of the 36 Commissions involved do have established policies, only 15 of them have developed plans or procedures for systematic regulation. Eight of these commissions have designed programs specifically for the regulation of utility-affiliate transactions while the rest of the programs are attached to rate and fuel adjustment clause cases. Thus, only about half of the Commissions have any type of regulatory policy and less than half have established programs to regulate utility-fuel affiliate relationships.

Methods of Regulation

Some indication of degree of regulation is the reporting and record-keeping requirement by the Commissions. Fifteen Commissions, less than half, require utilities to report on one or more subjects. In only two of the eight categories for which information was requested did half or more of the Commissions require recordkeeping.

Some Commissions have determined that their approval is required for certain types of utility-affiliate transactions. Although approval of a transaction would be a stronger regulatory requirement than recordkeeping of the transaction, less than half of the Commissions require approval of any of the six types of transactions for which information was requested.

Regulatory Emphasis

The major regulatory emphasis is on pricing: what the affiliate charges the utilities, what the return on investment is to the utility and to the affiliate; what service charges the utility may pay the affiliate. Records are required on pricing, return on investment and service charges in a relatively large number of states. Approval of prices by Commissions is required in 14 states.

In the regulation of utility-affiliate relationships some Commissions focus on the business practices of affiliate fuel companies, as accounting techniques, external financing, directorate interlocks, and the physical operations.

Another focus of regulation is on the contractual agreements between utilities and their affiliates. Approval of agreements is a requirement in 12 states. Records of agreements are required in 20 states; however, records of compliance with agreements are required in only 11 states.

A fourth area of regulatory emphasis is on the opportunity for outside competitors to bid against affiliates. Bidding and competition issues are not covered in reporting requirements and receive little attention in recordkeeping and approval requirements.

The following six tables (taken from the original study, but without the accompanying extensive comments) describe the various activities and extent of PUC regulation of transactions between electric utilities and their fuel affiliates.

TABLE B-16

State Commissions With A Policy. Plan or Program of Regulation of Utility Fuel Affiliates

State Commissions	Commissions with a Policy Respecting Utility-Affiliate Transactions		Commission Permission Required to Form Fuel Affiliate		Commission With Plan, Program or Procedures for Regulation of Utility-Affiliate Transactions	
	Yes	No	Yes	No	Yes	No
Arizona	X			X		X
Arkansas	X		X		X	
California	X			X		X
Connecticut		X	X			X
Florida	X			X	X	
Idaho	X (in orders)			X	In rate cases	
Illinois	X		X		X	
Louisiana	X			X	X	
Maryland		X	X			X
Massachusetts		X	X(direct affiliate only)			X
Michigan	X			X	In rate cases	
Minnesota */	X			X		X
Montana	(developing)			X		X
New York	X		X			X
North Carolina		X	X		Rate & FAC hearings	
North Dakota	X			X	" " "	
Ohio	X		X		X	
Oregon	X			X	X	
Pennsylvania	X		X		X	
South Carolina	X			X	X	
South Dakota	X			X	X	
Texas	X			X	In rate cases	
West Virginia	X		X		X	
Wisconsin	X		X			X

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*/ The Minnesota Commission has a policy although no utilities under its jurisdiction have active fuel affiliates.

TABLE B-17A

Reporting Requirements for Utility-Affiliate Fuel Companies (States With a Policy on Electric Utility Arrangements With Fuel Affiliates)

State	Arrangements & Transactions		Affiliate External Financing		Directorate Interlocks of Affiliate Fuel Companies		Operational Aspects	
	Yes	No	Yes	No	Yes	No	Yes	No
Arizona		X		X		X		X
Arkansas	X		X			X		X
California		X		X		X	X	
Florida		X		X		X		X
Idaho		X (in rate cases)		X		X		X
Illinois	X		X			X	X	
Louisiana		X		X		X		X
Michigan		X		X		X	X	
Montana		X		X		X		X
New York	X		X			X	X	
North Dakota		X		X		X		X
Ohio	X		X		X		X	
Oregon	X		X			X		X
Pennsylvania	X		X		X		X	
South Carolina	X		X			X	X	
South Dakota		X		X		X		X
Texas	X		X			X		X
West Virginia	X		X			X	X	
Wisconsin	X		X		X		X	
Wyoming	X		X		X		X	
Total*/	11	9	11	9	4	16	10	10

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*/ Minnesota's State Utility Commission has a policy although no electric utilities under its jurisdiction have active fuel affiliates.

TABLE B-17B

Reporting Requirements of State Utility Commissions (States Without a Policy About Electric Utility Arrangements with Fuel Affiliates)

State Utility Commission	Arrangements & Transactions		Affiliates External Financing		Directorate Interlocks of Affiliates		Affiliate Operational Aspects	
	No	Yes	No	Yes	No	Yes	No	Yes
Colorado	X		X		X		X	
Connecticut	X			X	X			X
Delaware	X		X		X		X	
Indiana	X		X		X		X	
Iowa	X		X		X		X	
Maryland		X		X		X	X	
Massachusetts		X	X		X		X	
Mississippi	X		X		X		X	
Missouri	X		X		X		X	
Nevada	X		X		X		X	
New Jersey	X		X		X			Storage
New Mexico	X		X		X		X	
North Carolina		X		X		X		X
Oklahoma	X		X		X		X	
Virginia		X		X	X		X	
Washington	X		X		X		X	
Totals	12	4	12	4	14	2	13	3
Total for Tables 17A & 17B	21	15	21	15	30	6	23	13

TABLE B-18

STATE UTILITY COMMISSION
RECORD KEEPING REQUIREMENTS

State	Utility-Affiliate Agreement		Pricing by Affiliate to Utility		Bidding Prior to Procurement from Affiliate		Accounting by Affiliate		Utility-Affiliate Transactions		Investment or Return on Investment in Affiliate		Affiliate Service Charges to Utilities		Compliance with Agreements	
	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
Arizona		X		X		X		X		X		X		X		X
Arkansas	X		X			X		X		X*		X	X			X
California	X		X		X		X		X		X		X			X
Colorado		X		X		X		X		X		X		X		X
Connecticut	X		X			X	X		X			X		X		X
Delaware		X		X		X		X		X		X		X		X
Florida	X		X		X			X		X	X		X		X	
Idaho	X			X		X		X		X		X		X		X
Illinois	X		X			X	X			X		X	X			X
Indiana	X		X			X		X		X		X		X		X
Iowa		X		X		X		X		X		X		X		X
Louisiana		X	X			X	X		X		X		X		X	
Maryland	X			X		X		X		X		X	X			X
Massachusetts	X			X		X		X		X		X		X		X
Michigan		X	X			X		X		X		X	X		X	
Minnesota	X		X		X		X			X		X	X			X
Mississippi		X		X		X		X		X		X		X		X
Missouri		X		X		X		X		X		X		X		X
Montana		X		X		X		X		X	X		X		X	
Nevada		X		X		X		X		X		X		X		X
New Jersey		X		X		X		X		X		X		X		X
New Mexico		X		X		X		X		X		X		X		X

TABLE B-18 (cont.)

STATE UTILITY COMMISSION RECORD KEEPING REQUIREMENTS

State	Utility-Affiliate Agreement		Pricing by Affiliate to Utility		Bidding Prior to Procurement from Affiliate		Accounting by Affiliate		Utility-Affiliate Transactions		Investment or Return on Investment in Affiliate		Affiliate Service Charges to Utilities		Compliance with Agreements	
	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
New York	X			X		X		X		X		X		X		X
North Carolina		X		X		X		X		X		X		X		X
North Dakota	X		X			X	X			X		X	X		X	
Ohio	X		X		X		X		X			X		X	X	
Oklahoma		X		X		X		X		X		X		X		X
Oregon	X		X			X		X		X		X	X			X
Pennsylvania	X		X		X		X		X		X			X	X	
Rhode Island		X		X		X	X			X		X		X		X
South Carolina	X		X		X		X		X		X			X	X	
South Dakota		X		X		X		X		X		X		X		X
Texas		X		X		X		X		X		X		X		X
Virginia			X			X		X		X	X			X	X	
Washington		X		X		X		X		X		X		X		X
West Virginia	X		X			X	X		X		X		X			X
Wisconsin	X		X			X	X		X		X		X		X	
Wyoming	X		X		X		X		X		X		X		X	
Totals	20	18	18	20	7	31	13	25	9	29	10	28	14	24	11	27

*Natural gas service

Note to Table 18: Among the 38 state commissions tabulated, two, those of Rhode Island and Minnesota, do not regulate electric utilities that have active fuel affiliates. These states are included because they have some reporting requirements.

TABLE B-19

STATE COMMISSION ORDERS
Utility - Affiliate Transactions

State Utility Commission*	Rate Case Opinion	Fuel Adjustment Clause Review	Affiliate Financing Request	Regulation
Arizona	X			
Arkansas	X			
California	X		X	
Colorado				
Connecticut			X	X
Florida				
Idaho	X			
Illinois			X	
Indiana		X		
Kentucky**				X
Louisiana	X	X		
Massachusetts				
Michigan	X		X	
Minnesota**				
Mississippi		X		
Montana	X			
New Mexico				Proposed
New York	X		X	
No. Carolina	X	X	X	
No. Dakota				
Ohio		X	X	X
Oregon	X		X	
Pennsylvania				X & Proposed
So. Carolina	X	X		X
So. Dakota	X			
Texas	X			
Virginia		X	X	
Washington	X			
West Virginia	X	X		
Wisconsin	X			
Wyoming	Pending		X	
Total	16 plus 1 pending	9	9	5 2 pending

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* Omits states for which questionnaire was inapplicable.
** States without utilities with fuel-affiliates.

TABLE B-20

ACTIVITY BY STAFF

In State Regulatory Proceedings
Utility - Fuel Affiliate Transactions

State Utility Commission	Audits of Affiliate	Review of Utility - Affiliate Transactions	Letter Orders
Arizona			
Arkansas	X		
California	X	X	
Colorado			
Connecticut		X	
Delaware			
Florida			X
Idaho	X	X	X
Illinois		X	
Indiana			
Iowa			
Kentucky			
Louisiana	X		X
Maryland			
Massachusetts			
Michigan			
Minnesota			
Mississippi			
Missouri			
Montana			
Nevada			
New Jersey			
New Mexico		Proposed	
New York			
No. Carolina	X	X	X
No. Dakota			
Ohio	X	X	
Oklahoma			
Oregon		X	
Pennsylvania			
Rhode Island			
So. Carolina	X	X	
So. Dakota		X	
Texas	X		
Utah			
Virginia		X	
Washington	X		
West Virginia	X	X	
Wisconsin		X	X
Wyoming			
Total	10	12 plus 1 pending	5

TABLE B-21

Aspects of Transactions Between Utilities and Their Fuel Affiliates for Which State Regulatory Approval is Required

State Utility Commission	Agreements	Pricing	Procurement Plan Competitive Opportunities	Accounting	Transactions	Service Charges to Utility
Arizona	X					
Arkansas					X	
California		X				
Connecticut		X		X		
Florida		X		X		
Idaho						
Illinois	X	X		X	Some reports	X
Louisiana		X		X		X
New Mexico	Proposed					
New York	X	X		X		X
No. Carolina	X	X	X	X	X	X
Ohio	X	X	X	X		
Oregon	X					X
Pennsylvania	X				X	X
So. Carolina	X	X	X	X	X	X
Texas		X				
Virginia	X	X				
West Virginia	X	X		X	X	X
Wisconsin	X	X	X	X	X	X
Wyoming	X	X	X	X	X	X
Total	12 plus 1 proposed	14	6	11	8	11

Senator D'AMATO. Mr. Rothschild.

STATEMENT OF EDWIN ROTHSCHILD, ENERGY ACTION PROJECT

Mr. ROTHSCHILD. Thank you, Mr. Chairman. My name is Edwin Rothschild. I'm the Director of the Energy Action Project of the Citizen/Labor Energy Coalition.

[Complete statement follows:]

ENERGY ACTION
2000 P STREET, NW, SUITE 310, WASHINGTON, DC 20036 (202) 466-8190

TESTIMONY OF
EDWIN ROTHSCHILD
DIRECTOR
ENERGY ACTION PROJECT
OF THE
CITIZEN/LABOR ENERGY COALITION
BEFORE THE
SUBCOMMITTEE ON SECURITIES
OF THE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
April 27, 1982

Mr. Chairman and members of the Subcommittee. We appreciate very much the opportunity to testify today on the need to preserve the Public Utility Holding Company Act of 1935. The Citizen/Labor Energy Coalition which represents over 200 citizen, labor union, senior citizen, religious and alternative energy organizations, is very concerned about efforts to repeal or seriously weaken the 1935 Act. Consumers of electricity and natural gas, for the most part, are captives of the local utilities which serve them. The Public Utility Holding Company Act is part of a framework of federal and state regulation which not only provides consumers with protection from the abuses of monopoly power, but also insures that utility service will be provided at rates that accurately reflect the actual costs of providing such service.

In its important 1971 study examining non-utility investments of regulated utilities an ad-hoc committee of the National Association of Regulatory Utility Commissioners (NARUC) stated,

> The "investment-revenue cycle"* has to continue to function effectively if utilities are to raise the large amounts of capital required to meet present and future demands for their vital service. 1/

A project of the
citizen/labor energy coalition

The ad hoc committee noted that "the practice of siphoning off substantial amounts of utility revenues to affiliated suppliers or service companies, thereby inflating substantially the total revenues needed to support any given investment" represents a serious "threat to the investment-revenue cycle." Such practices are outlawed by the Holding Company Act. As a result the financial integrity of utilities subject to the Act is preserved, while consumers are assured that what they pay for is what they get.

For over 45 years the Public Utility Holding Company Act has protected electricity and natural gas consumers from costly financial manipulations and abuses on the part of utility owners and managers. Some utility executives, hoisted on the petard of their own miscalculations and short-sightedness, are now urging the repeal of this law on the grounds that it prevents their companies from raising needed capital. These companies argue that the Act prevents them from diversifying their investments and thus insuring a financially healthy utility. What they do not say is that they would like to use the creditworthiness of the utility operation to diversify into more risky ventures that may pay off at higher rates than continued investment in the utility. If the venture is successful, the primary beneficiary is the utility company stockholder, not the ratepayer. As the National Association of Regulatory Utility Commissioners concluded in 1971,

> If a public utility engages in substantial diversification and is successful, the principal beneficiary is the stockholder not the utility consumer. If diversification proves to be unsuccessful, the stockholder is injured and the risk is great that the utility customer will be injured as well. The stockholders of a utility may win or lose as the result of divserification, but the consumer bears the risks of failure without any commensurate participation in the benefits of success. 2/

Since we have had more experience dealing with the natural gas industry and very little experience with the electric utility industry, I would like to specifically address the importance of the Act with respect to the natural gas industry. Except for the three gas companies -- Columbia, Consolidated and National Fuel Gas -- which are subject to the Act, no other gas utilities are organized as holding companies subject to the Act. Nevertheless, the existence of the Act prevents interstate gas pipeline companies, for example, from acquiring gas distribution companies. If the Act were to be repealed or weakened in any way, it would open the door for the large interstate pipelines, which in most cases have diversified their operations extensively over the past 15 years, to integrate forward into distribution.

This poses a very serious problem for consumers. In view of the fact that the major interstate pipelines have diversified, primarily by becoming gas producers as well as transporters of natural gas, serious monopoly consequences would result if they also could acquire distribution companies. While interstate pipelines are regulated under the Natural Gas Act, deregulation of natural gas prices could enable pipelines to earn monopoly profits on their own production. Thus, the Justice Department has observed,

> If a pipeline's transportation facilities are subject to effective rate regulation, but no effective regulatory check exists over the price it pays for gas from its own production operations, the pipeline would be able artificially to inflate the price it pays for its own gas. This

> will raise the rate-regulated pipeline's accounting costs, which the pipeline passes onto consumers. These additional "costs" will be additional profits to the pipeline's production arm and to the firm as a whole. Theoretically, by raising the internal transfer price of its own gas, the pipeline could obtain a profit for gas equivalent to that of an unregulated pipeline. 3/

Similarly, the Justice Department is also concerned about the consequences arising out of pipeline acquisitions of distribution companies. The Department points out that an acquired distribution company

> Acquisitions of distribution companies by natural gas pipelines can...confer market power on the pipeline or enhance that market power. A distribution company owned by the pipeline it serves is not likely to seek to switch to another pipeline supplier in the face of a rate increase by its affiliated pipeline. A wholly owned distribution company is also unlikely to intervene in support of an alternative pipeline supplier seeking certification to serve its load. Moreover, consumers of the distribution company are unlikely to be able to switch to another source of gas, because distribution companies are generally given a franchised monopoly by the state. 4/

Of course, it is the existence of the Public Utility Holding Company Act that prevents interstate pipeline companies from acquiring distribution companies. Acquisition would subject the acquiring pipeline to the provisions of the Act. These provisions would, in our view, require the pipeline to divest itself of many of its previous non-utility acquisitions. As a result acquisition of a distribution company would not appeal to pipelines, which is precisely why such acquisitions have not occurred.

By preventing interstate pipeline acquisitions of local gas distribution companies, consumers have been protected in a number of ways. The independent local utility, reflecting the needs of its customers, is often willing to challenge rate increase requests made by the pipeline company supplier. If the distribution company were part of the pipeline company, it would no longer fight pipeline rate requests. In addition, the local distribution company is willing to participate in both regulatory and legislative proceedings on the federal level often in opposition to the positions adopted by the pipeline companies. This is true, for example, with respect to the current debate over accelerated decontrol of natural gas prices. The organization known as Associated Gas Distributors (AGD), composed of gas distribution companies along the East Coast of the United States, steadfastly opposes accelerated gas decontrol, while the Interstate Natural Gas Association of America (INGAA), the organization representing interstate pipelines, favors an accelerated schedule.

Gas consumers have little enough protection as it is. By repealing or weakening the Public Utility Holding Company Act, consumers would be even more at the mercy of large, essentially unregulated gas companies.

Another public benefit of the Act is the fact that it prohibits companies subject to it from engaging in corporate take-overs, unless approved by the Securities and Exchange Commission. Without the Public Utility Holding Company Act, companies not engaged in the utility business could acquire local distribution companies. Under the Act, the acquisition of two or more gas distribution companies, would require regsitration as a utility holding company. Furthermore, the acquisition of just one distribution company would require an exemption under the Act. Thus, the Act prevents companies not in the utility business from acquiring local distribution companies. It is a prohibition designed to protect the financial integrity and creditworthiness of the distribution company and to keep it out of the hands of corporations which might otherwise seek to abuse the special status of regulated utilities.

Still another benefit of the Act is the fact that it prohibits, unless the Commission makes a finding that it is in the "public interest," companies subject to the Act from engaging in conglomerate-type mergers. The Act requires that any merger by a company subject to the Act should provide a vital function to the utility. Thus, the Commission has allowed electric utilities, for example, to go into the coal business when the coal production is, for the most part, used to fuel the companies coal-fired boilers. This is an extremely important prohibition. Without it, a holding company could divert money received from the sale of natural gas or electricity to non-utility related investments. It could thereby increase its debt capital relative to equity capital and increase the risk, that is, increase the cost of financing, the utility. Such risks are not in the public interest, because of the necessity to insure reliable utility service at reasonable prices.

Without proper regulation as provided, in part, by the provisions of the Public Utility Holding Company Act, natural gas consumers would be subject to excessive costs and risks that companies enjoying monopoly power could obtain from captive customers. One should view the Act as one views a standing army. We do not eliminate or weaken the army, because we don't use it every day. It is there as a deterrent letting any would-be trouble-makers know that they would face a terrible adversary if they chose to violate the peace. The Holding Company Act is a deterrent to any would-be monopolist seeking to acquire monopoly power.

If the Act were such an anachronism, I doubt that there would be any effort on the part of the utility industry to repeal or weaken it. It is precisely because the Act requires either registration as a holding company, or exemption from registration as a holding company--that is, coming under SEC surveillance -- that makes it so important. Obviously, in comparison to the period following its enactment, there is little, if any, effort to dis-member some of the holding companies against which the Act was specifically directed. Nowadays the Act is preventive. It works by restraining anti-competitive and anti-public interest activities in which utilities might wish to engage. I can understand why some utility companies would like to weaken or eliminate this law, just like I can understand why the Mafia would like to see the laws against racketeering repealed. Both laws protect the society. Those who argue in favor of repeal of or weakening amendments to the Public Utility Holding Company Act are really seeking a return to the evils which required enactment in the first place.

FOOTNOTES

*"The financing of investor owned public utilities rests upon two inter-locking regulatory roles. First, investors furnish funds which are invested in facilities needed to provide public utility services. Regulatory surveillance of public utility security issues is intended, among other things, to assure that capital furnished by utility investors is indeed utilized to finance public utility facilities. Second, recipients of public utility services must pay enough for the utility's services to cover necessary costs and provide sufficient "return" to retain and attract required capital. The regulatory commission in fixing utility rates assures that over the long term the necessary revenues are forthcoming from utility customers." (from "Report of the Ad Hoc Committee on Non-Utility Investments," National Association of Regulatory Commissioners, 1972, p. 709.)

1/ Ibid., p.710.

2/ Ibid.

3/ From a speech by Ronald G. Carr, Deputy Assistant Attorney General, Antitrust Division, Department of Justice, before the American Gas Association, March 31, 1982, p.4.

4/ Ibid., p.9.

Senator D'AMATO. Mr. Luntey, Mr. Lewis, both Mr. Richardson and Mr. Rothschild suggested in their testimony that diversification might benefit stockholders but could pose some problems for ratepayers, and might be injurious to the operation of the utility. In addition, I think Mr. Rothschild touched on a point of some concern to this Senator and which has been expressed to me by others, that is, the possibility of interstate pipeline companies having the ability to acquire local distribution systems without any limitation. Do you see that as a possible problem?

Mr. LUNTEY. May I answer the question on diversification first? Brooklyn Union did a study on the effects of diversification on the stockholder and on the ratepayer. Of course, one of the things that a company has to do is finance and our study quite clearly showed that the gas distribution companies who have a reputation for diversification sold much closer to their book value on the common stock market than did those who were strictly urban gas distribution companies.

Now that means that you can finance your company at much better rates, much closer to book. Consequently, both the stockholder and the ratepayer benefit from those lower capital costs. There is not a single——

Senator D'AMATO. If I might interrupt, you're saying that that study also indicated that the rates of those gas companies that have diversified are also lower?

Mr. LUNTEY. Well, I can't say that we showed that because there are so many jurisdictions involved. However, the cost of financing for those companies, which is one element that enters into the rate determination by those commissions, was definitely lower in the case of companies who had a reputation for a wider interest than just a straight gas distribution company.

Senator D'AMATO. On this point, I understand that it should follow, since your ability to raise capital at lower rates is an important ingredient in the overall rate structure, that therefore the rates would be lower.

I think that that is a key, or at least an important ingredient in the determination that the Congress will make. I suggest to those who advocate deregulation or advocate repeal or amendment of the act, that that information be forthcoming and that you go the extra step so that you are in a position to answer Mr. Rothschild's and Mr. Richardson's concerns—at least to that extent—with the facts. So I'd ask if you would undertake this effort so that at future hearings we will have the benefit of these facts. I think it should not be too difficult to carry the study that you have done that one more step. And I think that's an important ingredient.

Mr. LUNTEY. Yes, I would agree with that.

I would like to comment on Mr. Rothschild's other point about the tremendous danger to this country of the interstate pipelines buying up all the distribution companies. First of all, there is certainly in the history of the natural gas industry no pipeline that will suffer the lower rate of returns that a distribution company gets on its investment. It would certainly dilute their investment. You will hear in your next set of hearings from two of the three registered holding company companies within our industry, Columbia and Consolidated. These companies have been under the act for a long period of time. They are two prime examples of pipelines who own distribution companies.

However, I am not quite sure what Mr. Rothschild's argument is. Columbia has distribution companies, production, and pipelines. They are a completely integrated gas companies, as is Consolidated. These are the only two instances that I know of where a pipeline and a distribution company are part of a holding company, under the act.

Senator D'AMATO. The question that I think naturally follows then is that, if a company has that kind of monopoly, as I believe it was characterized in the testimony, would its ratepayers be placed at a disadvantage because the interstate system might not be subject to the same safeguards imposed by the State jurisdictions.

Mr. LUNTEY. You will hear later from people in both those companies and I think that's a very legitimate question to ask them, but it certainly flies in the face of Mr. Rothschild's argument.

Senator D'AMATO. Mr. Lewis.

IMPACT ON CUSTOMER COSTS

Mr. LEWIS. One comment I would make about the impact on customer costs is that in most rate proceedings this question of the cost of capital accounts for a relatively small part of the total revenue requirement from the customer.

For instance, in some of our companies, the cost of fuel alone accounts for well in excess of 50 percent of total cost of operation, in one case as high as about 80 percent. So even though you could show and demonstrate—which I believe you can—that a lower cost of capital would benefit ratepayers, you couldn't automatically say, therefore, the bills to the customers served by that company would be lower than some other customer because there are some other elements of costs which are so much larger in proportion than is just the cost of capital.

We would be pleased to provide to the committee some information that has been put together perhaps at the next hearing on how we believe companies that are diversified as against those that are not have fared in terms of the financial community's appraisal of them, and I think we ought to remember that Mr. Benore who is generally regarded as one of the very top security analysts following utilities gave you his personal opinion, that his impression is that generally those that have diversified have done better. He thinks they are better than are those who have not diversified.

This matter of management keeps cropping in and I would like to point out that the people who manage utility companies are like the people who manage other businesses. They're not all dunces. They're not all totally ignorant. And, in general, I believe you'd find that when they face a situation with respect to which they have no specific experience, they go get the experience. And I could cite some instances in which we've done that in our own system when we got into the matter of having to build a fleet to move fuel oil when our gas was curtailed by Federal action and the failure of gas suppliers to deliver; we went out and hired some people who were experienced in running boats and in operating a fleet on the river.

When we got into the bit of exploring for oil and gas to burn in our powerplants, we went out and hired a man who came out of the business of gas exploration.

So it's not as though you were totally restricted to just the people you have on hand at any point in time. You shape your management to meet the challenges that confront you

Senator D'AMATO. Another issue which has been raised is whether, without the Holding Company Act, adequate controls would exist to prevent overreaching in transactions between affiliates in the holding company. Mr. Richardson contends that the State commissions are not able to exercise control over these transactions.

What specific comments would you have on this issue?

Mr. LEWIS. Well, I would certainly take issue with that. I would cite the instance that I made reference to. We have a fuels company that was set up in 1972 with SEC consent to go out and buy, acquire, transport, and deliver fuel when we had to get into the fuel oil business where we had not been before in any significant way. And I would say to you that that is, by far, the most audited, most inspected, most scrutinized part of our whole system. The auditors have almost had to make reservations in order to come and find a time when there was an office in which they could work, and this was by State commissions, and they require us in some cases to file quarterly reports. So they are perfectly competent, either with their own people or hire people out of one of the big eight firms as one of the commissions does, to do periodic audits to determine that the costs are reasonable.

So I think they've demonstrated that they don't have to depend on the SEC to tell them that the cost that they're being asked to approve being passed on are reasonable or not. They check it for themselves.

RISKS OF INVESTMENT IN UTILITIES

Senator D'AMATO. In discussing diversification, Mr. Richardson, you stated that the earnings from nonutility sources are considered riskier than those from utility sources. While this has certainly been the case historically, I think that in recent years investment in utilities may have become a higher risk undertaking. Wouldn't you agree with that?

Mr. RICHARDSON. I'm not sure, Mr. Chairman, that I understand the question. Is it simply that utilities have been recently riskier investments than other industries?

Senator D'AMATO. Investment in utilities has become a highly risky undertaking today, as the market has indicated, with the exception of the last several days when we've seen a rather strong move in that area. But you wouldn't characterize the risk associated with investment in utilities as greater than that in businesses, would you?

Mr. RICHARDSON. Well, Mr. Chairman, I think many market analysts, certainly in the recent months, have been recommending and highly touting utilities as very good, very firm investments, so I don't think——

Senator D'AMATO. Because they're so depressed.

Mr. RICHARDSON. Because there are changed circumstances. For example, the last year, 1981, State commissions granted over $8 billion in rate relief to the investor-owned utility industry, an indication that State commissions are taking perhaps a better view—a more appropriate view on their functions as rate regulators. In changing circumstances, the industry is finally recognizing that we have gone from a declining cost industry to an increasing cost industry. This has had an impact on what could be characterized as a grow and build philosophy. Growth programs are being slowed down to meet lower anticipated future need. The necessity for raising additional capital is reduced. And all of these factors are leading to a number of analysts suggesting that utility stock is in fact a very good investment.

Senator D'AMATO. Then you disagree with people who say that the current ability to attract financing is unfavorable?

Mr. RICHARDSON. I would disagree, yes.

Senator D'AMATO. Well, there are many studies which indicate that in maybe all but very few areas of the country, that that's just not the case. The fact of the matter is that utilities throughout the length and breadth of this country are having a great deal of difficulty attracting adequate capital.

The local utility where I live is in a rather precarious position. And there are other utilities. The fact that rate increases have recently been granted in the amount of some $8 billion, to use your example, demonstrates a tremendous need for capital and the tremendous cost attendant to raising it. In many cases, this means that necessary capital expenditures cannot be undertaken in spite of the need. And with regard to the issue of diversification into alternative sources of energy and the utilization of non-fossil fuels, moving away from the importation of foreign oil, I would suggest that there is going to be a tremendous need for capital infusion in these areas.

So I guess we look at the recent upward swing in utility stocks from two different points of view. Mine is basically that the industry has been so depressed that it is making a readjustment and obviously management is aware that only those projects that are most essential can go forward because of the tremendous cost of capital today.

But I would like to commend you, Mr. Richardson, for raising some questions that I think are important and need answering. Who will ultimately benefit from modification or repeal of the act? If utilities are permitted to diversify further, would that make financing cheaper, and would any cost savings then be passed on to the consumer as well as to the stockholder? Can we expect that, if not to an outright repeal, at least modifications to the act would enable the utility companies to do their business in a more effective manner? And I think there are important issues.

Mr. RICHARDSON. If I could just make one or two points. Studies, of course, of diversified versus nondiversified companies have taken place in today's context with the act in place. This basically means you're looking at utilities that are diversified in functionally related areas. And our concern, of course, is the act is a prophylactic and it prevents inappropriate investment and it provides a means of limiting situations, or setting things right if bad decisions are taken.

In terms of cost of capital, the economist for the Wisconsin Public Service Commission, Robert Malco, in an article, "Utility Diversification: Devilish or Divine," addresses the risk question and he says:

> If the risk by an activity succeed and become profitable, the effect on the utility's ability to raise capital is uncertain. This is because of the way the financial markets respond to risks. If two firms earn the same earnings but the earnings of one are more subject to volatility, investors will expect a higher rate of return from the firm with more volatile earnings. If the risk of diversification causes investors to change their perception of the earnings volatility of the utility, the utility may find itself paying more for its utility capital as a result of diversification.

So there are obviously two sides.

Senator D'AMATO. Certainly. And I say that that's one of the important issues we must address.

Then, of course, there is the question of what regulatory agency should be charged with providing protection against potential abuses in specific areas? Should that authority die do you put that with FERC, the Federal Energy Regulatory Commission? Is FERC's authority under existing law adequate for this purpose as some contend? These are some of the specific points that we will be addressing in our future hearings.

Mr. RICHARDSON. Yes, and these are very specific points which I addressed in the testimony which I didn't read, fortunately probably for all of us, but I have addressed them certainly.

Senator D'AMATO. Well, we will leave the record open for any additional comments that you might like to submit.

I would like to thank all of our panelists. Do you want to make another provocative statement?

Mr. ROTHSCHILD. No, not a provocative statement.

Senator D'AMATO. Not the one on the last page?

Mr. ROTHSCHILD. I'd like to submit the speech by the Deputy Assistant Attorney General of the Antitrust Division, Ronald Carr, who addressed these issues of integration by pipeline companies, and they are not just my own views but the views of the Department of Justice of the United States.

Senator D'AMATO. We would be delighted to accept that. So ordered.

[Speech by Ronald Carr follows.]

REMARKS BY RONALD G. CARR, DEPUTY ASSISTANT ATTORNEY GENERAL BEFORE THE AMERICAN GAS ASSOCIATION, MARCH 31, 1982

It is an honor to be here today to discuss the application of the antitrust laws to your industry. The Antritrust Division has a history of efforts to encourage competition in regulated industries. The Division believes strongly in letting the competitive market work freely—a view I trust you all share. The competitive market, free of both government regulation and cartel control, is the most efficient mechanism for allocating the nation's scarce resources. We believe, however, that even where regulation for some purposes is necessary, competition still may have an important role to play. Competition and regulation can—and do—complement one another, even in the pervasively regulated natural gas industry.

One always confronts something of a problem in deciding what to discuss in an after-lunch talk. Antitrust is not, by nature, light fare, and of course it is, at the least, singularly impolite to risk inducing indigestion. At the same time, there is also a risk, of significant magnitude, although opposite effet, in repeating what must be familiar generalities about the basic purposes and prohibitions of the law.

To an audience with the sophistication of this, it seemed to me that the latter risk is greater than the former, and that, in any event, you must want to hear from me, not what you already know, but about antitrust questions that are relatively novel, about which there is possibly in your minds some significant doubt, or that, at least, have particular pertinence to your industry. I have therefore chosen a subject that is somewhat heavy going, but that I hope you will find of interest—the antitrust questions that are raised when natural gas pipelines acquire production or distribution companies, and companies in other fields.

Such acquisitions, as you know, must generally be approved by the Federal Energy Regulatory Commission under the Natural Gas Act. The Securities and Exchange Commission must also approve mergers by public utility holding companies under the Public Utilities Holding Company Act of 1935. But even if these agencies have already approved a merger or acquisition, it may still be challenged under the antitrust laws—specifically, under section 7 of the Clayton Act.[1]

Section 7 prohibits mergers and acquisitions that may substantially lessen competition. In determining whether a specific merger or acquisition meets this standard, the existence of the regulatory environment must be taken into account. It is regarded, however, "simply as another fact of market life."[2]

Antitrust analysis must look beyond the mere fact of regulation and determine its impact on competition in the particular case. Regulation can be a two-edged sword. While regulation may be designed to cure certain economic problems, it also may create possibilities of competitive concern unique to the regulated environment.

At least some natural gas pipelines are likely to possess some degree of market power. That is, absent rate regulation, they probably could profitably raise prices significantly above competitive levels. An investigation of the natural gas industry by the Federal Trade Commission in 1936[3] found that natural gas pipelines were able to dominate the purchase and sale of natural gas and that prices charged to consumers for that gas were excessive. The Natural Gas Act was passed in 1938 in part to remedy the ability of the pipelines to abuse any monopoly power they might have. Under the Act, rates are intended to be set at levels that will just permit the pipeline to recover its prudently incurred costs, as well as a reasonable return on its investment. Such regulation attempts to restrain the pipeline's rates to the level that would prevail if competition were present. For the purposes of my remarks, I will assume—although perhaps, in some instances, the assumption is heroic—that rate regulation of natural gas pipelines effectively accomplishes this intended result.

As interpreted by the federal courts, the Natural Gas Act also subjected wellhead natural gas prices to regulation. The Natural Gas Policy Act of 1978 ("NGPA") provided for partial deregulation of wellhead prices and much of it will be deregulated by 1985. For convenience, I will assume total deregulation for the remainder of my remarks, although total deregulation is not essential to my conclusions.

Acquisitions by natural gas pipelines are of concern because they provide an opportunity to evade the effects of regulation of the pipeline's rates. In other words, they may allow the pipeline to extract monopoly profits and concomitantly reduce supply and thus cause resource misallocation—results that regulation, properly directed, is intended to prevent. This is most easily seen in the case of backward vertical integration by a pipeline into production of natural gas. If a pipeline's transportation facilities are subject to effective rate regulation, but no effective regulatory check exists over the price it pays for gas from its own production operations, the pipeline would be able artificially to inflate the price it pays for its own gas. This will raise the rate-regulated pipeline's accounting costs, which the pipeline passes on to consumers. These additional "costs" will be additional profits to the pipeline's production arm and to the firm as a whole. Theoretically, by raising the internal transfer price of its own gas, the pipeline could obtain a profit for gas equivalent to that of an unregulated pipeline.

We believe that acquisitions that could have such effects would be subject to Section 7 challenge. The Division will analyze any vertical acquisition by a natural gas pipeline of gas reserves or of companies owning gas reserves under this theory. We will attempt to determine whether the theory fits the facts in the particular situation. The first issue will be whether the natural gas pipeline possesses market power. A firm has market power if, in the absence of rate regulation, the firm could profitably increase its rates significantly above the competitive level. The presence of rate regulation is not relevant to the existence of market power; it affects only the ability to exercise that power. Whether any particular pipeline has market power depends on the extent to which either buyers would switch to other pipelines to obtain gas or ultimate consumers would switch to products other than gas if the pipeline were to increase its rates.

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[1] *Federal Maritime Commission* v. *Seatrain Lines, Inc.*, 411 U.S. 726, 744 n.11 (1973); *California* v. *FPC*, 369 U.S. 482 (1962).

[2] *International Telephone and Telegraph Corp.* v. *General Telephone & Electronics Corp.*, 518 F. 2d 913, 935 (9th Cir. 1975); see also *United States* v. *Marine Bancorporation, Inc.*, 418 U.S. 602 (1974).

[3] S. Doc. No. 92, 70th Cong., 1st Sess., pt 84A (1936).

Whether ultimate consumers will switch to other products depends on whether there are any close substitutes for the use of natural gas. The most obvious substitute products are propane, heating oil and electricity. At present, natural gas has a distinct price advantage over these other energy resources. Although wellhead pricing deregulation will dissipate this price advantage to some degree, most analyses we have seen indicate that natural gas prices will not rise to the point where these other products will become good substitutes.

Whether consumers of gas will switch to other sources of gas in the face of a rate increase must be analyzed in two steps. First, can the ultimate consumers switch to another distribution company not served by the pipeline? There are likely to be inherent economies of scale in gas distribution that make it a "natural monopoly." That is, it probably is not economically practical or desirable for more than one distribution company to serve consumers in a given area. Moreover, natural gas distribution companies are frequently given an exclusive franchise to serve all consumers in some geographic area by the appropriate state public utility commission, so that gas distribution generally would be a monopoly even if not a natural monopoly. Thus it is unlikely that an increase in rates by the pipeline will cause the ultimate gas consumers to switch to another distribution company.

Second, in the face of a rate increase by the pipeline will distribution companies that buy from the pipeline switch to other pipelines to obtain gas? The extent to which this will occur will depend, in part, on whether the distribution company is served by more than one pipeline. If it is, the question will be whether that other pipeline has sufficient capacity and gas available to serve the distribution company's needs. If another pipeline is not currently serving the distribution company, it will be necessary to determine whether any other pipelines in the area have sufficient available gas supplies and could economically construct the facilities necessary to serve the distribution company.

Even if another pipeline could economically serve the distribution companies in question, FERC regulation imposes barriers to such a switch. FERC must certificate the sale of gas by a pipeline; it has approved certification of an alternative supplier to serve another pipeline's existing load only on rare occasions. It will approve such a switch of suppliers only where customers will benefit significantly from lower rates by the new supplier, and the other customers of the rejected supplier will not be greatly damaged.[4] Consequently, FERC regulation may actually be a factor contributing to the existence of a pipeline's market power.

If the Division determines that the pipeline proposing to acquire gas reserves has market power, the next step in our analysis will be to determine whether FERC regulation of gas costs is effective in preventing circumvention of regulation of the pipeline's rates. Under the NGPA, FERC still retains jurisdiction to regulate pipeline rates; inherent within that jurisdiction is the regulation of gas costs that are part of a pipeline's cost of service. It is, therefore, important to know how FERC will treat the price of pipeline-owned gas in setting the pipeline's rates.

The NGPA specifies that first sales of gas between an interstate pipeline and a pipeline affiliate shall be deemed just and reasonable if the price does not exceed the amount paid in comparable sales between the pipeline and independent producers.[5] Pass-through of such costs to consumers is guaranteed by the NGPA, unless FERC finds that the amount paid was excessive due to "fraud, abuse, or similar grounds." [6] FERC has recently indicated that the latter provision will be interpreted narrowly and is not to include the concept of imprudence in gas purchasing.[7] FERC seems to be indicating that the availability of other, lower gas prices is essentially irrelevant to the issue of the appropriate level of gas costs a pipeline may pass on to consumers. If this is so and a pipeline is assured that the price of its own gas will be deemed reasonable so long as it pays at least the same price to some independent producers, the pipeline will have an incentive to pay some independents a higher than competitive rate for the sole purpose of assuring regulatory approval of its own affiliate's prices.

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[4] *See, e.g., Cincinnati Gas & Electric Co.* v. *FPC,* 389 F.2d 272 (6th Cir.), *cert. denied,* 393 U.S. 826 (1968).

[5] 15 U.S.C. 3431(b)(1)(E).

[6] 15 U.S.C. 3431(c)(2).

[7] Statement of Policy, FERC Docket No. Public Law 82-1 (Issued: Feb. 4, 1982).

Furthermore, if the price paid to independent producers is the only benchmark FERC will use in determining whether the price of pipeline-owned gas is reasonable, a pipeline may be able to circumvent such regulation easily by purchasing all of its gas from pipeline affiliates. Several cases currently pending at FERC can be expected to clarify the standards to be applied in regulating such prices. To the extent the procedures adopted by FERC allow pipelines to pass supra-competitive prices for pipeline-owned gas to consumers, a pipeline with market power will be able to circumvent pipeline rate regulation by acquiring gas reserves or gas-producing companies.

To summarize, the Division will scrutinize with care acquisitions of production companies and gas reserves by natural gas piplines. Where we find that a pipeline has market power and is likely to be able to circumvent rate regulation by passing excessive gas prices through to consumers, the Division will challenge the acquisition.

Acquistions of distribution companies by natural gas pipelines can exacerbate the competitive problems I have just described because such acquisitions can confer market power on the pipeline or enhance that market power. A distribution company owned by the pipeline it serves is not likely to seek to switch to another pipeline supplier in the face of a rate increase by its affiliated pipeline. A wholly owned distribution company is also unlikely to intervene in support of an alternative pipeline supplier seeking certification to serve its load. This fact may make it even more difficult for the alternative supplier to obtain needed FERC approval. Moreover, consumers of the distribution company are unlikely to be able to switch to another source of gas, because distribution companies are generally given a franchised monopoly by the state. These facts may enable a pipeline to secure market power by acquiring distribution companies. By making such acquisitions it can assure that customers are not likely to switch to other suppliers if it raises its rates.

A pipeline can also increase its market power by acquiring a distribution company, even if that company is also served by another pipeline. A distribution company that is served by more than one pipeline will generally have contracts with both, specifying the amounts of gas it may purchase monthly or annually from each supplier. Such contracts frequently contain provisions that require the distribution company to buy a minimum amount of gas each month or pay for that gas, even if it does not take delivery. Despite such contractual constraints, the distribution company may have considerable discretion to choose among these suppliers in purchasing its gas needs. The acquired distribution company may have an incentive to purchase the gas of its affiliated supplier even if the price of that gas is higher than that of the competing pipeline. If the distribution company can pass the higher gas prices of its affiliated supplier through to consumers, it will prefer to purchase from its affiliate since purchases from the affiliated pipeline will help to assure that the pipeline will collect its allowed rate of return. FERC does not scrutinize such discretionary purchasing decisions except perhaps insofar as they may be relevant to certificating sales for future demand growth. Moreover, our experience suggests that state commissions may be lax in their oversight of such purchasing decisions. Consequently, the Division will closely scrutinize acquisitions by natural gas pipelines of either gas reserves or distribution companies.

Up to this point, I have discussed only mergers and acquisitions within the natural gas industry—essentially vertical intergration issues. The Division is also concerned with acquisitions by regulated companies in the industry of unregulated companies not in the natural gas industry. Our concerns about such diversification are similar in many respects to the concerns I have outlined over vertical integration. By diversifying, a regulated entity will acquire the opportunity to allocate joint and common costs properly associated with its non-regulated enterprises to its regulated business and in this way circumvent rate regulation of the regulated business. To the extent such costs are misallocated, they will be passed through to consumers in the form of higher retail gas costs. Costs to the non-regulated enterprise that are erroneouly allocated to regulated operations will not appear on the books of the unregulated enterprise. As a result, the unregulated enterprise will appear to be that much more profitable. Our experience in the *AT&T* case has convinced us that regulators are unlikely to be able to police such activities adequately, and we see no reason to be less concerned about this problem in the natural gas industry. Accordingly, the Division will scrutinize proposed diversification by natural gas companies with considerable care.

At the outset, I said that I had chosen to talk to you today about the particular problems posed by pipeline acquisitions rather than more broadly about the general antitrust policies and prohibitions. But the particulars take on meaning only if the general context is understood. And so, I hope you will pardon me for lapsing into generalities, and familiar ones at that, in some concluding thoughts. The antitrust laws preserve and promote a concept in which I hope we all believe. In its essentials, the antitrust laws are concerned with the preservation of competition as a means of achieving in a world of scarcity a critical social good—the allocation of the limited resources of society in the most efficient way. By encouraging competition, the antitrust laws promote the most efficient use of resources in a way much more effective and less painful than regulation. And where the marketplace can effectively work without regulation, the Division has for some time been a prime mover in eliminating unnecessary and stifling regulation.

But the indispensable predicate to deregulation and competition are the antitrust laws, which assure that the market, freed of government regulation, will not become subject to equal or greater social loss from cartel control. It is our purpose to encourage competition to assure that the economy will grow and thrive by infusing initiative, technological advances and the most efficient operational and management techniques. These are ideals that, I trust, all of us share. They will become increasingly important to the natural gas industry as deregulation progresses.

Thank you.

Senator D'AMATO. I would like to thank the panelists for their time and efforts.

This hearing is adjourned.

[Whereupon, at 12:50 p.m., the hearing was adjourned, to reconvene on June 8, 1982.]

PUBLIC UTILITY HOLDING COMPANY ACT AMENDMENTS

TUESDAY, JUNE 8, 1982

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Subcommittee on Securities,
Washington, D.C.

The subcommittee met at 9:45 a.m., in room 5302 of the Dirksen Senate Office Building, Senator Alfonse M. D'Amato (chairman of the subcommittee) presiding.

Present: Senators D'Amato and Schmitt.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'Amato. The subcommittee will come to order.

This morning, the Subcommittee on Securities will continue its comprehensive review of the Public Utility Holding Company Act of 1935. This statute was enacted 47 years ago to put an end to abusive practices which existed in the utility industry at that time. It was also intended to protect public utility investors and ratepayers of the future from recurrences of such practices, through direct regulation of the financing and expansion of utility holding company systems.

But today, when the Nation's utilities face difficult financial problems which necessarily affect the same investor and ratepayer interests, the extensive regulation put in place by the Holding Company Act may actually be restricting their ability to improve their financial condition.

The purpose of these hearings is to reexamine both the purposes and current consequences of this act. Through this process, the subcommittee hopes to determine whether there is still a need for additional investor and ratepayer protection in our modern regulatory environment and, if so, what statutory provisions would best be suited to this end.

Several proposals to amend various provisions of the Holding Company Act and a bill to repeal the act are now before the subcommittee. On the first day of these hearings, April 27, the subcommittee was provided with an overview of the major issues raised by these proposals. During this morning's hearings and our hearings on Thursday, we plan to explore these issues in further depth.

We will hear today from the Justice Department, and the relevant Federal and State regulators of utilities and utility systems—the Securities and Exchange Commission, and the National Association of Regulatory Utility Commissioners. We will then hear testimony from certain businessmen who are likely to be competitors of utility holding company systems if the limitations on utility diversification are relaxed: the American Supply Association and the National Association of Plumbing, Heating and Cooling Contractors. We will also hear testimony from the Honorable Tom Lewis, State senator of New Mexico.

On Thursday, the hearings will continue with testimony from the Attorney General of Rhode Island; a panel of executives from utility companies which participated in the drafting of S. 1869, S. 1870, and S. 1871; and a panel of other interested parties, including representatives of the Cabot Corp., Citizens Utilities Corp., and Morgan Stanley, Inc.

We are pleased to welcome as our first witness today John Shad, Chairman of the Securities and Exchange Commission, accompanied by one of the Commission's distinguished members, Commissioner Bevis Longstreth.

Welcome, Commissioners. I'm sorry for the delay. We're happy to have you with us.

STATEMENT OF JOHN S. R. SHAD, CHAIRMAN, ACCOMPANIED BY BEVIS LONGSTRETH, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION

Mr. **SHAD**. Chairman D'Amato and members of the subcommittee, at Chairman D'Amato's request last November, the SEC reviewed the amendment to the Public Utility Holding Company Act proposed by various industry groups. The Commission unanimously recommended repeal of the act for the following reasons:

REASONS FOR REPEAL OF THE ACT

The Commission concluded that, although there were valid arguments in support of the proposed amendments, their enactment would be tantamount to repeal of the act. The Commission would be left with the appearance of oversight, but minimal regulatory authority.

The Commission also concluded that the principal purpose of the act, simplification or elimination of the multitiered electric and gas holding companies, was accomplished over 20 years ago.

At one time or another since 1938, 223 holding companies have been registered under the act. Today, only 12 are still required to obtain prior Commission approval of their intrasystem transactions, acquisitions, and financings. These 12 active systems represent 20 percent of the Nation's electrical utility assets and 8 percent of our natural gas distribution assets.

The act also inhibits the financing alternatives, acquisitions, and geographical expansion of some 90 exempt holding companies. None of the Nation's other utility holding companies—and I think this is an important point—none of them—including telephone, sewage, pipeline, transportation, communication, and other companies—are subject to comparable Federal regulation or inhibition.

Repeal will remove the element of unfairness now present in application of the act's substantive provisions to only 20 percent of the industry. It is a common misconception that the Commission regulates 100 percent of the industry. In fact, we are talking about a small piece of the industry.

The Commission has also concluded that if the act is repealed, the economic, industry, and regulatory fundamentals which permitted the abuses of half a century ago will not recur, for the following reasons:

From 1902 to 1927, electrical generation capacity doubled every 5 years. Electric utilities were a dynamic growth industry. Improving technology permitted rate reductions, which expanded demand; they also benefited from the introduction of new electrical appliances and equipment, and rising urban populations, as the Nation's population was moving into the cities from the agricultural areas.

These favorable fundamentals resulted in high rates of return on the capital actually invested in generation facilities. Paper profits were pyramided through highly leveraged, multitiered holding companies. State and Federal rate regulation and disclosure requirements were lax to nonexistent. There were no uniform accounting standards or requirements. Assets were reappraised upward to facilitate financings.

The investing public was unsophisticated. Credit was cheap, and margin requirements were low; 10 percent, and sometimes lower.

Today, sophisticated institutional investors account for 70 percent of the market in all listed stocks and half of the over-the-counter market. Accounting standards are uniform and highly refined.

The SEC enforces full and accurate disclosure of all issuers and surveils the securities industry and the accounting profession. The Federal Energy Regulatory Commission regulates wholesale interstate utility rates and other matters that relate to this industry, including standardized accounting requirements.

The State commissions have developed increasingly effective rate and other regulations. They also have their own generally accepted accounting standards and formats for reporting. Services publish objective, qualitative bond ratings. Holding company securities are rated lower than operating company securities, because they are riskier. Credit is dear and the FRB margin requirements are high; 50 percent.

Investment bankers no longer create and control utilities. Investment banking and brokerage has become a highly regulated service industry. Electric and gas utilities are no longer glamorous industries. Neither the industry's image nor its economics will support highly leveraged, multitiered holding companies today.

If the act is repealed, these holding companies will continue to be subject to the SEC's registration and reporting requirements, and their operating subsidiaries will continue to be subject to rate and other regulations by FERC and the State commissions.

DETERIORATION OF FINANCIAL CONDITION

A common misconception is that the SEC regulates rates under the act. Such has never been the case. The SEC only regulates the intrasystem transactions, acquisitions, and financings of the 12 active holding companies. It should be noted, in the latter regard, that over the past several years there has been a serious deterioration in the financial condition of the Nation's electric and gas utilities.

On balance, their bonds are being downgraded. Their interest and construction costs are soaring. And their stocks are selling at 20 percent discounts from book value. As of April this year, the common stocks of these 12 companies were selling at an average 25 percent discount from their book values.

Nevertheless, they are being forced to do dilutionary equity financings, in order to hold their bond and credit ratings. This is like eating your seed corn. It provides a meal at the expense of next year's crop.

Obsolete plants need to be replaced, and additional capacity is required to meet future consumer demands. In order to finance such requirements, these 12 companies must improve their profitability. Repeal of the act is not a panacea, but it will increase their financing, acquisition, and other alternatives—alternatives which these companies, like all other utility holding companies, should be permitted to pursue in order to improve their profitability and strengthen their financial condition, which, in turn, will permit them to better serve their utility customers.

They are certainly not going to be in a better position to serve customers if their financial condition continues to deteriorate.

For these reasons, the burden should be upon those who would retain an act which served its purpose over a generation ago.

Thank you.

[The complete statement follows:]

STATEMENT OF THE U.S. SECURITIES AND EXCHANGE COMMISSION CONCERNING PROPOSALS TO AMEND OR REPEAL THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

June 2, 1982

I. INTRODUCTION

Congress is now considering several proposals, introduced as S. 1869, S. 1870, S. 1871, and H.R. 5220 to amend the Public Utility Holding Company Act of 1935 ("Act" or "1935 Act"). Three of these bills would effectively repeal the Act as it applies to particular industry segments. The fourth, S. 1869, so extensively amends the Act as to approach repeal for the entire industry, although some administrative responsibilities would be left with the Commission. Together they approach total repeal.

The Commission does not believe that effective repeal of the Act as to one industry segment could be justified without considering whether the basic premises of the Act as applied to all public utility holding companies are still valid. While S. 1869 approaches repeal, it would leave the Commission with the continued appearance of oversight in the face of severely reduced regulatory authority and no clearly surviving purpose for the remaining regulation.

After considering these proposals and evaluating the results of its administration of this statute, the Commission concluded that the Act had accomplished its basic purpose and that its remaining provisions now, to a large extent, either duplicate other federal or state regulation or otherwise are no longer necessary to prevent recurrence of the abuses which led to its enactment. The Commission has therefore unanimously recommended that Congress repeal the Act. This recommendation was transmitted to Senator D'Amato in a letter dated December 21, 1981. Since the Commission's decision, repeal legislation has been introduced in Congress as S. 1979, H.R. 5465, and H.R. 6134. _/

This statement explains the Commission's reasons for recommending repeal of the Act. It includes a summary of the events which led to passage of the Act, a description of the holding company structures which the Congress sought to eliminate, and review of the Act's administration by the Commission for the past 47 years. This information is essential to understanding both the structure and the complexities of the Act and the Commission's reasons for now recommending that it be repealed.

The Commission's decision to recommend repeal of the 1935 Act was based primarily on significant developments since 1935 in federal and state regulation of electric and

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_/ A brief summary of the amendment proposals is attached as Appendix A. The Commission will provide the Committee with detailed technical comments on these proposals and also on the repeal bills if so requested.

gas utilities, the disclosure and financial reporting requirements now applicable to most publicly-owned companies, and changes in the accounting profession and the investment banking industry. Developments in all these areas now provide investors and consumers with a wide range of protections unforeseen in 1935. In addition, the present maturity of the utility industry, not to mention its financial difficulties, makes recurrence of the boom mentality and accompanying speculation that characterized the industry in the 1920's unlikely and perhaps impossible.

Other factors were considered in the Commission's determination to recommend repeal. The very thoroughness of the industry's reorganization pursuant to the 1935 Act raises questions about the continued fairness of subjecting the remaining 12 registered systems to the Act's detailed substantive regulatory requirements. This issue is made even more acute by the Act's requirement that the Commission base its actions on the economic merits of financings or other transactions proposed by the management of registered systems, thereby involving the Commission deeply in the substance of fundamental management decisions. In making these substantive economic determinations, the Commission is directed to act in the interest not only of investors, but of consumers as well -- a mandate that differs significantly from the other federal securities laws, which are administered for the protection of investors and focus primarily on disclosure and on the integrity of the nation's securities markets.

Finally, the Commission believes that the continued need for the Act must be considered in the context of the substantial changes that have occurred in the electric and retail gas industry since 1935. This industry is no longer the highly profitable business it was when the Act was passed and for many years thereafter. While the 1935 Act did not cause the industry's problems and its amendment or repeal would not resolve them, the Act is premised on the assumption that public utilities should be structured in a particular way, with stringent geographical limitations and restrictions on investments outside the utility industry. Congress has not reexamined these basic presuppositions since 1935. Questions are now being raised as to:

a. whether the limitations on diversification and geographical expansion are in the best interests of investors and consumers;

b. whether the generation of electricity is still a natural monopoly; and

c. whether the 1935 Act discourages non-utilities from undertaking cogeneration projects or otherwise acts as a barrier to entry by non-utilities into the area of generation.

Continuation of the 1935 Act constitutes, in effect, a judgment that the industry today should conform to a structure deemed best in 1935. The Commission believes that the Congress should consider whether the Act now locks the public utility industry into a structure that is no longer responsive to changing market conditions or to the nation's energy needs.

II. HISTORY AND STRUCTURE OF THE 1935 ACT

A. Growth of Public Utility Holding Companies

The twenty years preceding the stock market crash of 1929 saw intense growth and expansion of the electric and gas utility industry in the United States. In the electric industry, generating capacity approximately doubled every five years between 1902 and 1927. _/ This extraordinary growth resulted in part from population increase and concentration in cities, as well as from the extension of service into new territories. In addition, improvements in technology and equipment resulted in the construction of larger and more efficient generators and expanded the area of economical transmission, thereby enabling the industry to concentrate generation of power in relatively large and economically-operated central stations. The industry's growth was further enhanced by the intensive market development made possible when progressive price reductions permitted the application of electric energy to many new purposes. _/

Similar, although less spectacular, growth occurred in the gas industry -- most notably after 1925 due to extension of interstate gas pipelines. The quantity (in cubic feet) of

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_/ I.R. Barnes, The Economics of Public Utility Regulation 31 (1942) (hereinafter "Barnes"). *See also* Federal Trade Commission Report to the Senate, "Utility Corporations," S. Doc. No. 92, pt. 72-A, 70th Cong., 1st Sess. 24 (1935) (hereinafter "FTC Report"), conducted pursuant to S. Res. 83, 70th Cong., 1st Sess. (1928).

_/ Barnes at 31-33.

manufactured gas _/ produced and marketed in 1929 was over five times greater than that in 1906. _/ Moreover, the value of natural gas marketed in the U.S. increased more than 880% over the same period, after the pipelines greatly expanded the industry's markets with a product much cheaper than manufactured gas. _/

Prior to 1920, holding company systems often brought great advantages to local utilities by combining small plants into interconnected regional systems. _/ In addition, the larger holding companies had access to the capital markets on better terms than small independant operating utilities. The larger, combined holding company systems could attract more skilled management and the expert engineering necessary to address the

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_/ When the Act was passed, most of the retail gas supplied in large parts of the nation was manufactured, principally from the process of reducing coal to coke. Because the process had become increasingly expensive, many smaller gas plants were closed and even metropolitan gas utilities became unprofitable. Extension of the availability of natural gas, particularly after the construction of major interstate pipelines in the 1930's and 1940's, resulted in an almost universal substitution of natural gas service, or propane gas distribution in areas inaccessible to the pipelines.

_/ FTC Report, pt. 72-A at 32 (Table 7).

_/ Barnes at 29 (Table 5).

_/ J.C. Bonbright, Public Utilities and the National Power Policies 23-24 (1940); *see also* 10 SEC Ann. Rep. 84 (1944).

problems involved in plant construction and in the production, transmission, and utilitization of electric energy. In their early stages, combinations of electric and gas utilities in a holding company system facilitated improvement and extension of service, encouraged greater consumption, and led to reductions in the costs of production and, ultimately, to lower rates for the consumer. _/

During the 1920's, however, holding companies acquired numerous and widely scattered utility properties throughout the United States and even in foreign countries. These acquisitions frequently bore no economic or functional relationship to other properties in the holding company system. Instead, vast and sprawling utility holding company empires were created and continued to grow enormously in the speculative period up through 1929. For example, the consolidated assets of the Associated Gas and Electric system grew from approximately $6 million in 1923 to $1 billion in 1929. __/ The capital assets of the North American Company grew from $9.2 million in 1901 to $132.7 million by 1929. __/

Holding company expansion in the 1920's was often stimulated both by investment bankers, who saw opportunities for profits and commissions from the sale of securities, and

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__/ FTC Report, pt. 72-A at 881.

__/ 10 SEC Ann. Rep. 84 (1944).

__/ FTC Report, pt. 72-A at 192.

by promoters, who saw opportunities to increase the sources from which they collected fees for management or engineering services. The realization of the variety and magnitude of available gains to be derived from the highly profitable and growing electric and gas industry caused intense competition among holding companies for the acquisition of yet more utility properties, in the course of which prices were frequently driven up to two to five times book value of the equity securities. _/ Acquisitions were frequently funded by the issuance to the public of debt securities based upon the inflated acquisition prices, with the expectation that the utility's earnings would cover these interest expenses and provide a profit to the parent holding company as well. Between 1924 and 1930, utility holding companies floated an estimated $5 billion in securities, the proceeds from which were used to purchase outstanding voting securities of additional operating utility companies -- that is, further expansion of the holding company empires -- rather than to build or improve utility properties. _/

One result of this competition among holding company empires was the increasing concentration of gas and electric utilities in fewer and fewer holding company systems, sometimes

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_/ FTC Report, pt. 72-A at 60-65. In an extreme example, one holding company paid a price 159 times book value for a controlling equity interest in another holding company. Id. at 64-65.

_/ 10 SEC Ann. Rep. 84 (1974).

under parent company managements that were neither experienced nor interested in local community needs. By 1932, eight major holding company systems controlled more than 67% of the electric energy generated by privately-owned plants. _/ During 1930, holding company systems also controlled 66.4% and 23.3% of the national production of manufactured and natural gas, respectively. _/ Four holding company systems controlled more than 56% of the total natural gas pipeline mileage and 15 holding companies controlled over 80%. _/ Gas and electric utilities were often combined under the control of a single holding company. For example, in 1930 the Electric Bond & Share group of holding companies controlled 7.4% of the total U.S. production of natural gas and 14.4% of the total electricity generated by privately-owned plants. _/

B. Holding Company Structures

This concentration of control was frequently accomplished through highly-leveraged financial structures at each level of the multiple tiers of partially-owned subsidiaries. Effective

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_/ FTC Report, pt. 72-A at 38 (Table 12).

_/ *Id.* at 48 (Table 16).

_/ *Id.* at 46 (Table 14).

_/ *Id.* at 38 (Table 12) and 47 (Table 15).

control of extensive utility complexes was thus achieved through minimum equity investments in the parent companies. _/ While enough voting stock was held within the systems to assure control, the great bulk of the capitalizations were represented by non-voting debt and preferred stocks held by the investing public. Generally five or six sub-holding companies separated the top parent from the operating utilities. In at least one instance, there were 12 companies in one line of control from top to bottom of the pyramid. _/

The pyramided capitalizations and corporate structures were often accompanied by "write-ups" of the assets of both the operating and holding companies, based on appraisals of utility properties by affiliated entities, frequently on sketchy evidence and without any check by state or federal authorities. This practice further decreased the equity investment required to control vast systems. Following the write-up of newly-acquired subsidiaries' assets, debt securities sold to the public would recoup initial cash outlays with the controlling common stock retained at little or no cost.

_/ The top holding company in the Associated Gas & Electric system provides an extreme example of the complex capital structures in these giant holding company systems. That holding company had a capitalization consisting of 3 classes of common stock, 6 classes of preferred, 4 classes of preference stock, 24 classes of debentures (some convertible into equity securities at the company's option), 7 issues of secured notes, 4 issues of investment certificates and various warrants and rights. 10 SEC Ann. Rep. 86, n.5 (1944).

_/ FTC Report, pt. 72-A at 159.

As a result of the highly-leveraged capital structures, small percentage increases in the earnings of the underlying operating companies were phenomenally magnified at the level of the top holding company's most junior equity securities. A conservative illustration in the FTC Report of the effects of pyramiding on the common stock earnings of the top company in a pyramid of five holding companies over the operating utilities shows a possible 295% return on net earnings of 8% on the underlying properties. Of course, this leverage also worked in reverse so that even the relatively small decreases in earnings of the operating companies during the early 1930's _/ had a significant impact on the top-heavy superstructure of holding company debt and preferred securities. Many companies within these systems stopped paying dividends and defaulted on debt securities, and some of the largest systems were forced into bankruptcy.

The investing public suffered losses of millions of dollars. The complex capital structures of these holding company systems, together with the lack of uniform accounting standards, also afforded many opportunities to direct profits or losses through intercompany channels. Such transactions obscured the true financial condition of the various companies within the system

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_/ FTC Report, pt. 72-A at 162-66 (Table XI).

_/ Electric and gas operating companies actually suffered less during the depression days of the early 1930's than almost any other substantial segment of the economy. Their operating revenues only dropped about 15% from the peak levels of the 1920's. 25 SEC Ann. Rep. at XVII (1959).

to the detriment of investors and the frustration of state regulators' efforts to establish fair rates for consumers. _/

C. Congressional Findings

Even before the 1929 crash, the vast size of public utility holding companies and the increasing concentration of control in the electric and gas industry caused Congressional concern. Pursuant to a Senate Resolution in 1928, the Federal Trade Commission ("FTC") undertook a study of the entire industry that spanned nine years and ultimately comprised 101 volumes. _/ A second, 6-volume study was conducted by the House Interstate and Foreign Commerce Committee between 1933 and 1935. _/ These studies identified myriad questionable practices and concluded that public utility holding company systems, as they

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_/ Comments of the Securities and Exchange Commission on the Comptroller General's Report of June 20, 1977, to the Congress on the Administration of the Public Utility Holding Company Act of 1935 at 6 (hereinafter "SEC Comments").

_/ FTC Report, supra note __.

_/ Report on the Relation of Holding Companies in Power and Gas Affecting Control, H.R. Rep. No. 827, 73d Cong., 2d Sess. (6 Vols. 1933-35), made pursuant to H.R. Res. 59, 72d Cong., 1st Sess. (1932) and H.R.J. Res. 572, 72d Cong., 2d Sess. (1933). The investigation that resulted in this Report was conducted by Walter M.W. Splawn, Special Counsel to the Committee on Interstate and Foreign Commerce, and the document is frequently referred to as the "Splawn Report" (hereinafter "Splawn Report").

then operated, were detrimental to both investors and consumers. _/ These reports, which have been called "some of the most exhaustive and comprehensive studies ever to underlie a federal statute,"_/ formed the factual basis for the 1935 Act.

The more significant conclusions were also listed in Section 1(b) of the Act and are briefly summarized as follows:

(1) inadequate disclosure to investors of the information necessary for them to appraise the financial position and earning power of the companies whose securities they purchase;

(2) issuance of securities against fictitious and unsound values;

(3) overloading operating utility companies with debt and fixed charges, which tended to prevent voluntary rate reductions;

(4) imposition of excessive charges upon operating utility companies for various services, such as management, construction work, and the purchase of supplies and equipment;

(5) control by holding companies of the accounting practices and rate, dividend, and other policies of their operating utility subsidiaries so as to complicate or obstruct state regulation;

(6) the control of holding companies and their subsidiaries through disproportionately small investment; and

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_/ The FTC Report listed some 19 different general categories of abuses. FTC Report, pt. 73-A at 62.

_/ North American Co. v. SEC, 327 U.S. 686, 701 n.11 (1946).

> (7) the extension of holding company system control and dominance over far-flung utility properties without regard to the integration and coordination of related properties.

D. Structure of the 1935 Act

The 1935 Act today consitutues a relatively small part of the overall federal regulation of electric and gas utilities. Structurally, it is Title I of the Public Utility Act of 1935 and the Federal Power Act (which greatly expanded the functions of the Federal Power Commission) is Title II of that same statute. While the Federal Power Act focuses upon questions of engineering, science and economics as applied to ratemaking and licensing proceedings, the 1935 Act is oriented primarily toward financial transactions, corporate structures, acquisitions and dispositions of assets, and potential conflicts of interest. It may be for this reason that Congress originally assigned administration of the 1935 Act to the Securities and Exchange Commission rather than to the Federal Power Commission.

It should be noted that the Securities and Exchange Commisson has no ratemaking responsibilities under the 1935 Act. The Federal Power Commission (now the Federal Energy Regulatory Commission) was given ratemaking responsibility under the Federal Power Act _/ for wholesale sales of electric energy in interstate commerce. The 1935 Act also does not

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_/ 16 U.S.C. § 824 *et seq.*

confer any jurisdiction on the Securities and Exchange Commission over gas pipeline systems, since the definition of "gas utility company" under the Act includes only those companies involved in the retail distribution of gas. _/ The Natural Gas Act of 1938 _/ conferred on the Federal Power Commission jurisdiction to regulate the pipeline systems through its authority to regulate wholesale sales of gas in interstate commerce.

The 1935 Act requires all companies that meet the statutory definition of a "holding company" either to register or seek an exemption. Registered holding companies and all their subsidiaries are then subject to significant substantive regulation under other provisions of the Act. Because of the complexity of the Act, its provisions are not identified in detail here but are discussed in a section by section analysis, included as Appendix B. The more significant requirements of the Act are summarized below:

1. Registration

Section 2(a)(7)(A) defines a "holding company" as any entity that owns 10% or more of the voting securities of an electric or retail gas utility _/ or of another holding company. The Act

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_/ Section 2(a)(4).

_/ 15 U.S.C. § 717 et seq.

_/ As noted, the Act's definition of "gas utility company" includes only those companies that own or operate facilities for retail distribution of gas. The definition of "electric utility company" is much broader in that it includes any company that owns or operates facilities used for the generation, transmission, or distribution of electric energy for sale.

requires all holding companies with subsidiaries engaged in the electric utility business or in the retail distribution of gas to register with the Commission or seek an exemption.

Because Congress did not consider all types of public utility holding companies to require regulation at the federal level, Section 3 of the Act authorizes the Commission to exempt holding companies from the registration and other provisions of the Act. The Commission is "directed" to exempt holding companies if they fall into one of five general categories. _/ However, under the so-called "unless and except" clause of Section 3, exemption is not required if the Commission determines that it would be detrimental to

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_/ The five categories for exemption are:

(1) when the holding company and its public utility subsidiaries are all organized and carry on their business substantially in one state (the "intrastate exemption");

(2) when the holding company is itself an operating public utility whose operations do not extend beyond the state in which it is organized and contiguous states (the "operating company" exemption);

(3) when the holding company is only incidentally a holding company and is primarily engaged in another business;

(4) when the holding company is only temporarily a holding company (e.g., a bank that acquires title to pledged securities);

(5) when the holding company is such only with respect to foreign public utilities.

the public interest or the interest of investors or consumers. _/ The Commission may also revoke an exemption if it finds that the circumstances which gave rise to the issuance of the exemptive order no longer exist.

2. Integration and Simplification of Holding Company Systems

Section 11 spoke directly to the issue of undue concentration of control within the industry and to the overly complex capital structures and inequitable distribution of voting power. This section sets forth the basic integration and simplification requirements of the Act and has frequently been referred to as "the very heart" of the statute. _/ It authorized the Commission to reorganize the registered holding company systems so that each was restricted to a single integrated electric or retail gas utility system having a simple capital structure. Additional utility systems and related incidental businesses could be retained only if specified standards were met.

_/ Section 3(a) provides that the Commission shall exempt holding companies and their subsidiaries that meet the criteria of that section from "any provision or provisions of this title, unless and except insofar as it finds the exemption detrimental to the public interest or the interest of investors or consumers."

_/ SEC v. New England Electric System, 384 U.S. 176, 180 (1966), citing, North American Co. v. SEC, 327 U.S. 686, 704 n.14 (1946).

Geographic and other limitations on the business of a registered holding company system are set forth in Section 11(b)(1) of the Act, which requires that each registered system be limited to a "single integrated public-utility system." The term "integrated public-utility system" is separately defined for electric and gas companies, but in both cases refers to a group of naturally related properties within a single area or region. Early in its administration of the Act, the Commission interpreted the single system requirement to mean that electric and gas properties within a registered system could not together constitute a "single integrated utility system." _/ A registered holding company must satisfy the standards for retention of an additional system if it desires to retain both an electric and a gas utility system.

Under Section 11(b)(1), non-utility businesses could be retained by a registered system only if "reasonably incidental or economically necessary or appropriate to the operations of [an] integrated public-utility system." In administering this provision of the Act, the Commission concluded that registered systems could retain businesses that supplied or served the utility system, such as coal mines or transportation systems.

_/ In Re Columbia Gas & Electric Corp., 8 SEC 443 (1941); In Re United Gas Improvement Co., 9 SEC 52 (1941). This interpretation was sustained by the Supreme Court in SEC v. New England Electric System, 384 U.S. 176 (1966).

In addition the Commission concluded that retention of gas and electric appliance businesses also met the statutory standard.

The Act's corporate simplification provisions are set forth in Section 11(b)(2), which requires elimination of unnecessary corporate complexities and redistribution of voting power on a fair and equitable basis among the securities holders of the entire holding company system. "Great-grandfather" holding companies were prohibited through the section's requirement that no more than two holding companies could exist over an operating utility in a registered system. This section required many holding company systems to recapitalize to achieve a simple structure with voting rights equitably distributed among all investors, and many intermediate holding companies were dissolved during this process. _/

3. Regulation of Financing, Acquisition and Disposition of Assets, Service Arrangements and Conflicts of Interest

Registered holding company systems are subject to substantive regulation of, among other things, all financings, acquisitions and mergers, and transactions with affiliates. These requirements were intended to prevent recurrence of holding company abuses by regulating the "activities of holding companies and their

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_/ 10 SEC Ann. Rep. 89 (1944).

subsidiaries * * * that were found to give birth to many of the evils about which Congress was concerned." _/

The more significant of these regulatory provisions include:

(1) Financings: Prior Commission approval must be obtained for most types of securities issuances by registered holding companies and their subsidiaries (Sections 6 and 7). Approval may be withheld if either the securities or the terms of their issuance fail to meet specified qualitative standards. Under Section 7, the securities may not be approved if the Commission finds, inter alia, that the security is not reasonably adapted to the security structure of the issuer and other companies in the same holding company system or not reasonably adapted to the earning power of the issuer, or if the financing in question is "not necessary or appropriate to the economical and efficient operation of a business in which the applicant lawfully is engaged or has an interest."

(2) Acquisitions: Prior Commission approval must be obtained for acquisitions of any securities or utility assets or any other interest in any business by registered holding companies or their subsidiaries (Sections 9 and 10). The Commission may not approve any acquisition that would be detrimental to carrying out the integration and simplification provisions of Section 11, which means that utility acquisitions must be confined to a single geographically-defined area and that non-utility acquisitions must be functionally related to the utility operations.

(3) Loans and other intercompany transactions: Loans from an operating utility to a parent holding company are prohibited and other types of intercompany transactions, such as loans from the parent holding company to the utility, are subject to regulation by the Commission (Section 12). The section also provides for Commission regulation of sales of public utility securities or assets and the solicitation of proxies and prohibits certain political activities.

_/ North American Co. v. SEC, 327 U.S. 684, 710 (1946).

(4) Contracts with affiliates: The Commission is authorized to regulate service, sales, and construction contracts between operating utilities within a registered system and associate companies, a term which includes other companies within the same system (Section 13). This section includes a statutory requirement that such services be performed at cost.

(5) Periodic reports: The Commission may require the filing of annual, quarterly, and other periodic reports by registered holding companies, and may require such reports to be certified by an independent public accountant (Section 14).

(6) Accounting practices: The Commission is authorized to establish the form of accounts and prescribe uniform methods for keeping accounts (Section 15).

Holding companies exempt from the registration provisions of the 1935 Act and operating utility companies generally are not subject to any of the above requirements, except to the extent that the same or similar requirements may be imposed under other federal laws. Section 9(a)(2) of the 1935 Act is a significant exception. That Section prohibits "any person" who already owns 5% or more of the voting securities of any public utility -- and is therefore a statutory "affiliate" of that company -- from acquiring 5% or more of the voting securities of another public utility without prior approval from the Commission.

III. COMMISSION ADMINISTRATION OF THE ACT

In the first few decades following passage of the 1935 Act, one of the Commission's major tasks was the reorganization of the electric and retail gas industry through administration and enforcement of Section 11(b) of the Act. There is a general consensus, which the Commission shares, that this task was completed at least 20 years ago.

As already described, Section 11 authorized the Commission to require that every registered holding company (1) limit its operations to a single integrated public-utility system, although it could retain, under certain circumstances, additional systems and reasonably incidental non-utility businesses, and (2) simplify its capital structure through the elimination of unnecessary holding companies and the equitable redistribution of voting power among security holders. The Senate Report expressly acknowledged that this was the most important part of the 1935 Act:

> "[T]he purpose of section 11 is simply to provide a mechanism under which effective federal and state regulation will be possible. It is therefore the very heart of the title, the section most essential to the accomplishment of the purpose set forth in the President's message." _/

Effective administration of the reorganization provisions of the Act began only after the Supreme Court's 1938 decision upholding the constitutionality of its registration provisions. _/ Even at the height of its administration of the Act, the Commission recognized that its functions under Section 11 were to a large extent self-liquidating. _/ By 1952, the Commission

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_/ S. Rep. No. 621, 74th Cong., 1st Sess. 11 (1935).

_/ Electric Bond & Share Co. v. SEC, 303 U.S. 419 (1938).

_/ 10 SEC Ann. Rep. 82 (1944).

announced that "the task of bringing about compliance with Section 11 which had its real beginning in 1940 is rapidly nearing completion." _/ The Commission continued:

> "Thus, in what is probably the only instance of its kind in the history of the nation, an entire major industry has been almost completely reorganized in the short space of 12 years and this has been accomplished with a staff which has declined steadily from 175 in 1940 to the present force of 35 employees engaged in this work in the fiscal year of 1952. When the work under Section 11 is completed in another couple of years there will be no further expense to the taxpayers on this score." (footnote omitted). _/

In 1959, the Commission reported to Congress in connection with its activities under Section 11 that:

> "[S]ecurities of the divested companies and of those registered companies which have completed their integration and simplification programs have an excellent acceptance. The utility industry as a whole is enjoying financial health and stability, and has been able to finance expansion programs of unprecedented proportions largely out of new money raised from the public sale of securities." _/

At one time or another since 1938, a total of 2,419 companies were registered under the 1935 Act, including 223 holding companies, 1040 utility subsidiaries and 1156 non-utility subsidiaries. _/ Many of these 223 holding

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_/ 18 SEC Ann. Rep. 82 (1952).

_/ Id.

_/ 25 SEC Ann. Rep. XXVII (1959).

_/ 28 SEC Ann. Rep. 83 (1962). As used in this statement, the term "non-utility subsidiary" means a subsidiary engaged in any business other that that of an electric or retail gas utility, as those terms are defined in the 1935 Act.

companies were intermediate ones serving no demonstrable economic purpose. As a result of the reorganization and simplification process mandated in Section 11, a total of 2,235 of these companies had been released from the regulatory jurisdiction of the Act by 1962. _/ Accordingly, about one-half of the largest utility companies presently operating are not subsidiaries of holding companies at all and are therefore outside the scope of the 1935 Act. In addition, a number of companies are currently exempt pursuant to Section 3 of the Act, approximately 90 of which because they are either predominantly intrastate or predominantly operating utilities. The Commission is not aware of any problems with the capital or corporate structures of either the independant operating companies or the exempt public utility systems.

The number of active registered holding company systems has been reduced to 12, _/ consisting of 66 utility subsidiaries and 53 non-utility subsidiaries as of December 31, 1981. These 12 systems consist of 9 electric and 3 gas systems with assets and revenues as of December 31, 1981, as follows:

_/ Id.

_/ There is one registered system that is considered inactive: Philadelphia Electric Power Co. The sole function of this company and its subsidiaries is to hold title to the Conowingo hydro-electric project, which is operated under lease by its parent, the Philadelphia Electric Company, an exempt holding company. Licensing and title complications have precluded dissolution of these companies, but they do no significant business.

Holding Company	As of December 31, 1981 (000 omitted)	
	Assets	Revenues
Allegheny Power System	$3,190,739	$1,607,461
American Electric Power Company, Inc.	11,567,039	4,192,645
Central and South West Corporation	4,643,244	2,055,318
Columbia Gas System, Inc.	4,616,781	4,426,243
Consolidated Natural Gas Company	2,850,653	2,738,164
Eastern Utilities Associates	426,821	297,931
General Public Utilities Corporation	5,054,021	2,065,487
Middle South Utilities, Inc.	8,318,556	2,771,788
National Fuel Gas Company (Sept. 30, 1981)	732,697	888,456
New England Electric System	2,292,085	1,282,101
Northeast Utilities	3,950,597	1,655,057
Southern Company	12,415,034	4,256,237
	$60,058,267	$28,236,888

These systems represent about 20% of the investor-owned electric utility assets and about 8% of gas utility asets. All are currently in substantial compliance with the geographical integration and corporate simplication standards of Section 11. The only reason for lack of full compliance is the continued retention of relatively minor gas operations by Middle South, American Electric Power, and Northeast Utilities.

The 1935 Act provisions in addition to Section 11 were intended to prevent recurrence of the abuses perpetrated through the public utility holding company structure in the 1920's. While most of these provisions do not apply to either exempt holding companies or to operating utilities,_/ they involve the Commission deeply in substantive management decisions of the

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_/ Section 9(a)(2) is an exception in that it applies to "any person" -- not just registered holding companies.

remaining 12 registered systems concerning matters such as financings and acquisitions.

The great bulk of the Commission's current activity under the 1935 Act relates to the financing of registered holding company systems, the standards for which are prescribed in Sections 6 and 7. In the 12 month period ended September 30, 1981, the Commission approved total financings of more than $11 billion. Other provisions of the Act dealing with mergers and acquisitions, service contracts, and other intrasystem transactions also continue to require significant attention.

From time to time, the Commission must also consider applications filed pursuant to Section 9(a)(2) of the Act, which requires prior Commission approval before any person -- not just one of the 12 remaining registered systems -- may become an "affiliate" under Section 2(a)(11)(A) of more than one electric or gas public utility. That section defines an "affiliate" of a specified company in terms of ownership of 5% or more of that company's voting securities. _/

The Commission's records indicate that compliance with the Act in fiscal year 1981 required a total of 830 filings, applications, and reports from the industry involving an estimated

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_/ A more detailed statement of the Commission's administration of the Act, prepared by Aaron Levy, Director of the Division of Corporate Regulation, is attached as Appendix C to this Statement.

69,000 hours to prepare. The Commission's Revised Budget Proposal for fiscal year 1982 shows that 20.3 staff years were devoted to 1935 Act administration in fiscal year 1980. Administration of the Act in fiscal year 1981 involved 18.2 staff years at a cost of $760,000. For fiscal year 1982, 17.0 staff years have been projected at an estimated cost of $795,000.

In June 1977, a General Accounting Office ("GAO") Report took issue with the Commission's view that its major responsibilities under the 1935 Act had been accomplished and questioned whether existing exemptions granted by the Commission should be continued. _/ The GAO Report recommended that Congress direct the Commission to make a study under Section 30 of the Act _/ of the developments in the gas and electric industry and determine the Act's continued overall usefulness.

The Commission response noted that the GAO criticisms were based, in large part, on a basic misconception of the Commission's role in administering the Act in that the reduction in the level of activity reflected attainment rather than abandonment of the

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_/ General Accounting Office, Report to the Congress, "The Force of the Public Utility Holding Company Act Has Been Greatly Reduced by Changes in the Securities and Exchange Commission's Enforcement Policies" (June 20, 1977) (hereinafter "GAO Report").

_/ Section 30 authorizes the Commission to make studies and investigations to determine the size, types, and locations of public utility companies which do or can operate most economically and efficiently in the public interest and the interest of investors and consumers.

Act's purposes. In addition, the response pointed out that the evils and abuses which gave rise to the passage of the 1935 Act had been virtually eradicated due to vigorous enforcement by the Commission during its first three decades and stated that "Congress did not intend that utilities would remain permanent federal wards under the Act."_/ The Commission concluded that the recommended study was not necessary in light of the industry's substantial reorganization since passage of the Act. _/

Starting as early as the mid 1940's, there have been a number of efforts -- some initiated by the Commission itself -- to transfer administration of the 1935 Act to the Federal Power Commission or, more recently, to the Department of Energy. _/

_/ SEC Comments, supra note ____, at 12.

_/ In evaluating the Commission's comments on its 1977 Report, the GAO concluded that no change in its recommendations had been justified and renewed its recommendation that Congress direct the Commission to make a study of the developments in the gas and electric utility industry under Section 30 of the Act. General Accounting Office, Report to Congress, "The Securities and Exchange Commission's Regulation of Public Utility Holding Companies: An Evaluation of Commission Comments on a Critical Report" (January 4, 1978). Some two and one-half years later, by letter dated November 13, 1980, the Commission reaffirmed its prior comments in response to a letter from Senator Metzenbaum dated July 25, 1980.

_/ The most recent effort was a 1977 proposal to transfer administration of the Act to the new Department of Energy.

The rationale for transfer was that the Commission's major task of integrating and simplifying the holding company systems had been largely completed and that consolidation of the remaining federal regulation of the gas and electric utility industry in a single agency would eliminate dual control and duplication of effort. These proposals all contemplated retention by the Commission of the same investor protection responsibilities for public utility holding companies that it has with respect to all other publicly-owned companies, including the reporting, proxy, insider trading and tender offer provisions of the Securities Exchange Act of 1934 and the full disclosure and other provisions of the Securities Act of 1933.

All transfer proposals were opposed by the registered systems, which gave as their reason for opposition their view that investor protections would be reduced in order to favor consumers. None, obviously, was successful.

IV. THE COMMISSION'S RECOMMENDATION

There are two primary reasons for the Commission's repeal recommendation. First, the main purpose of the 1935 Act -- reorganization of the nation's electric and retail gas utility holding companies -- has been accomplished. Second, the abuses by which holding companies had exploited investors and frustrated effective state regulation of utilities are not likely to recur, for reasons extrinsic to the Act. The bases for the Commission's conclusion that these abuses would not recur are set forth in more detail in this part of the Commission's statement.

A. Investor Protections

It was probably investors who suffered most acutely from the public utility holding company abuses that ultimately resulted in passage of the 1935 Act. The difficulty of obtaining accurate and adequate information was greatly exacerbated by the lack of uniform accounting standards, the absence of which permitted the issuance of securities against arbitrarily written-up asset values or in anticipation of excessive operating profits. As a result, the Act clearly addressed the inability of investors to obtain adequate information regarding holding companies and their subsidiaries.

The 1935 Act addressed this problem by requiring Commission approval before any registered holding company or its subsidiaries could issue most types of securities. That approval must be based on the economic merits of the proposed financing, which must meet certain qualitative standards prescribed in Section 7 of the Act. The Act also authorizes the Commission to require periodic reports from registered holding company systems

(Section 14), and to prescribe uniform systems of accounts for registered holding company systems and their subsidiaries (Section 15).

As described above, all the 1935-vintage public utility holding companies have long been reorganized and simplified in accordance with the standards of the 1935 Act. It is the Commission's judgment that investors in the remaining registered systems no longer need the special protections of the 1935 Act. These 12 systems now represent only about 20% of the electric industry and 8% of the gas industry. There appears to be no continuing basis for believing that their investors require more protection than investors in exempt holding companies or operating utilities, or, for that matter, in any other industry. This conclusion is based on significant changes that have occurred since 1935 in a number of areas, most notably in the development and extension of the concepts of disclosure and financial reporting under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"), the development of uniform accounting standards, and changes in the investment banking industry.

1. Development of Disclosure and Financial Reporting Standards under the Securities Act and the Exchange Act

While the Securities Act and the Exchange Act (collectively referred to as the "Securities Acts") became law prior to passage of the Public Utility Holding Company Act of 1935, the Commission in 1935 was only one year old and had barely begun to carry out its mandate. _/ Since 1935, the concepts of disclosure and financial reporting under the Securities Acts have been greatly developed and expanded. If the 1935 Act were repealed now, investors in public utility holding companies would still have available from other sources essentially the same information called for under the 1935 Act. _/

Several developments have made the disclosure and financial reporting requirements of the 1935 Act redundant. As originally enacted, the Exchange Act required only those companies with securities listed on a national exchange to register those securities with the Commission and to file annual and other periodic reports with the Commission.

_/ Congress also believed that more than disclosure would be required to correct the existing abuses and accordingly directed the Commission to reorganize the industry. As noted, however, reorganization of the industry was completed 20 years ago.

_/ There are some reports required by the Commission under the 1935 Act that are not duplicated in the reports required under the Securities Acts. Reports under the Securities Acts are generally submitted on a consolidated basis. Form U-13-60 under the 1935 Act for service companies in a registered system includes intrasystem transactions with the service company that are eliminated in the consolidation. Two other 1935 Act annual reports, Form U5S and the Rule 2 annual filing for exempt holding companies also break down the consolidated statements into company-by-company statements. These reports are of greater interest to state utility regulators than to investors.

Similarly, the short-swing insider trading and proxy solicitation provisions of the Exchange Act applied only to companies with listed securities. Initially, many of the public utility holding companies registered under the 1935 Act were not listed on a national exchange and were therefore not subject to these provisions. Disclosure under the 1935 Act became essentially insignificant as the industry was reorganized into integrated operating or holding company systems whose securities were so listed, and completely so in 1964, when the registration requirements of the Exchange Act were expanded to include all companies with more than $1 million in assets and 500 shareholders. _/ All registered holding companies, and most exempt ones, meet these standards. _/

The regulatory system under the Securities Acts has also been extended by Commission rules effectuating statutory provisions, such as those relating to proxy solicitation and antifraud authority, which are not self-executory, as well as by statutory additions to the Commission's authority.

_/ The Commission recently exempted publicy-owned companies with assets of less than $3 million from the registration requirements under the Exchange Act. Securities Exchange Act Release No. 18647 (April 15, 1982), 25 SEC Docket 2080 (April 27, 1982). Even with the higher asset level required, most investor-owned public utility holding companies would still be required to register their securities under the Exchange Act.

_/ Approximately 20 exempt holding company systems are not subject to the Exchange Act registration provisions, mostly because they are substantially privately held.

The tender offer provisions added to the Exchange Act in 1968 are a significant instance of authority conferred on the Commission to require from nearly all publicly-owned companies disclosures that did not exist when the 1935 Act was passed. Thus, over the nearly 50 years since passage of the Securities Acts, the Commission has developed a comprehensive system of regulation requiring sophisticated financial reporting and full and prompt disclosure of all material information by all public companies, including both registered (and exempt) public utility holding companies.

2. Development of Uniform Accounting Standards

The absence of uniform accounting standards was identified by Congress as a major reason that adequate financial information was not available to investors. _/ The Act accordingly empowers the Commission, in Section 15, to require the keeping of accounts and records using uniform methods prescribed by the Commission. In the judgment of the Commission, changes since 1935 have made this continued authority over the accounting practices of registered systems unneccessary.

Since 1935, extensive accounting and recordkeeping requirements have been developed under the Securities Acts. Section 13(b)(1) of the Exchange Act authorizes the Commission to prescribe accounting methods pursuant to which the financial

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_/ As discussed later, lack of uniform accounting standards also permitted holding companies and their subsidiaries to avoid rate reductions, thereby adversely affecting consumers as well as investors.

statements of all publicly-held corporations must be prepared. Section 7 of the Securities Act (and Schedule A thereunder) confers similar authority on the Commission for the financial statements included when securities are registered under that Act. The Commission's Regulation S-X establishes the standardized form and content for all registration statements and reports filed pursuant to both Securities Acts. In addition, the Commission has stated its views on a wide variety of accounting and auditing principles in nearly 300 Accounting Series Releases _/ and in Staff Accounting Bulletins where particular issues of financial disclosure warrant more extensive discussion and analysis.

Another significant change since 1935 consists of the uniform systems of accounts established by the Federal Energy Regulatory Commission ("FERC") (formerly the Federal Power Commission) for both electric and gas utility companies operating in interstate commerce. _/ In addition, almost every state has also adopted uniform systems of accounts for electric or retail gas utility companies operating within its jurisdiction. Many of these state uniform systems of accounts are essentially identical to those promulgated by FERC.

Uniform accounting and auditing standards have also been developed by the private accounting profession. The Financial

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_/ These releases were recently codified in "Financial Reporting Release No. 1", Securities Act Release No. 6395 (April 15, 1982), 25 SEC Docket 1962 (April 27, 1982).

_/ 18 C.F.R. pts. 101, 104, 201, and 204.

Accounting Standards Board ("FASB") has been designated by the accounting profession as the body to establish accounting principles and it has done so in numerous areas. In addition, the American Institute of Certified Public Accountants has established ethical standards for auditors which prohibit them from certifying without exception any financial statements prepared according to accounting principles other than those enunciated by the FASB. _/ The Commission can also take disciplinary action under its Rule 2(e) against auditors who certify inadequate financial statements filed with the Commission.

In recognition of these developments, the Commission in 1975 withdrew the uniform system of accounts previously established for registered holding companies under Section 15 of the 1935 Act. _/ Thus, if the 1935 Act were repealed, investors would continue to have available the type of financial disclosure necessary to evaluate the financial position and earning power of public utility holding companies and their subsidiaries.

3. Changes in the Investment Banking Industry

Changes in the investment banking industry since 1935 also make it unlikely that investor abuses would recur. Prior to passage of the 1935 Act, investment bankers had assumed a dominant role in the management, as well as the financing, of the public utility holding companies and were regarded as

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_/ AICPA Code of Professional Ethics Rule 203, 2 Accountancy L. Rep. ¶ 65,517 (CCH).

_/ 40 Fed. Reg. 22,129 (1975).

prime culprits in the holding company abuses identified in the Federal Trade Commission and Congressional industry studies. Some of the largest holding company systems had been organized by investment bankers for the purpose of acquiring new clients or protecting existing banking relationships. The National Power Policy Committee, _/ reporting in 1935, stated:

> "Fundamentally, the holding company problem always has been, and still is, as much a problem of regulating investment bankers as a problem of regulating the power industry." _/

As a result of this experience, the Act prohibited investment bankers from serving as officers or directors of registered holding company systems or their subsidiaries, except as the Commission should permit by rule or regulation. In addition, the Act requires prior Commission approval of the fees and other charges associated with underwriting new issues of securities in order to assure that these costs are reasonable.

The investment banking industry itself, however, has changed radically since the 1935 Act was passed. It is subject to a fully established system of regulation and oversight by the Commission under the Exchange Act. _/ Most underwriters also

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_/ This group was an interdepartmental committee appointed by President Roosevelt in 1934 and composed of those persons in the government most concerned with the then-current power problems. The first draft of what is now the 1935 Act was prepared by this Committee in collaboration with leaders in the House and Senate. The Committee's report is appended to S. Rep. No. 621, 74th Cong., 1st Sess. (1935).

_/ Id. at 55.

_/ Cf. infra note ____ (p. 44).

belong to one of the industry's self-regulatory organizations, such as a national securities exchange or the National Association of Securities Dealers ("NASD"). The NASD has established standards to assure fair and equitable treatment of underwriting clients by member firms. These organizations also have the statutory responsibility under the Exchange Act of imposing and enforcing the requirements of the federal securities laws and the rules promulgated by the Commission thereunder, as well as the rules of the self-regulatory organization itself.

In addition, the concepts of liability to investors under the Securities Acts were essentially undeveloped in 1935. Today, investors who rely on false or misleading statements in purchasing public utility securities may seek relief in private actions against the underwriter. Accordingly, underwriters of new issues customarily perform so-called "due diligence" inquiries to assure that full and accurate disclosure has been made in connection with the offering.

Another change in the private sector is the growth of a sophisticated community of professional financial analysts, often specializing in a particular industry such as electric or gas utilities. Such analysts observe the capital structure of issuers for undue complexity or other evidences of unsoundness. Highly-complex pyramided structures such as those which prevailed in the 1920's in the electric and gas utility industry would be readily detected and would make most and perhaps all of the company's securities unmarketable. In addition, securities rating services evaluate the financial reports, business, and structure of issuers before rating its securities. A favorable rating from such a service has become a practical prerequisite to successful marketing of the securities. These developments thus discourage recurrence of the pyramided corporate structure prevalent in the utility industry in the 1920's and help assure that the financial and other disclosures by utility companies are reflected in the market price of their securities.

4. Summary

The Commission is confident that investors in registered public utility companies would remain adequately protected should the Act be repealed. This does not mean, however, that every provision of the 1935 Act is duplicated in other federal regulation. Most notably, Sections 6 and 7 of the Act require prior Commission approval of the issuance of securities based on the Commission's judgment concerning the economic merits of the proposed issuance. No such qualitative review is required by the Commission for the securities of any other publicly-owned company, including utilities in exempt holding companies or operating utilities. The Commission does not believe that this special protection is required any longer for investors in registered public utility holding company systems.

B. Consumer Protections

In contrast to its role under the other statutes within its administration, the Commission's mandate under the 1935 Act includes the protection of consumers as well as that of investors. This reflects Congress' view that the abuses in the public utility holding company system permitted the operating utilities to evade effective state regulation and thereby tended to prevent rate reductions. Thus, a second major purpose of the Act was to make it possible for operating utilities to be subject to effective state regulation.

It is important to recognize, however, that the 1935 Act addressed mainly the corporate structure and organization that permitted these abuses to occur. Federal regulation of the rates and service of electric and gas utility operations has always been conferred on a different agency altogether. Protection of consumers through federal regulation of rates, control over interconnection and coordination of facilities, and an "array of other activities in furtherance of [electric] energy capability," _/ has been entrusted to the Federal Power Commission, now the Federal Energy Regulatory Commission. Such regulation has never been the function of the Commission under the 1935 Act. _/ Such regulation commenced in 1920 with the enactment of the Water Power Act, administered by the Federal Power Commission. _/ Enactment of the Federal Power Act in Title II of the Public Utility Act of 1935 greatly expanded the authority of the Federal Power Commission. Three years

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_/ City of Lafayette, Louisiana v. SEC, 454 F.2d 941, 951 (D.C. Cir. 1971).

_/ Id. at 955-56; see also Alabama Electric Coop., Inc. v. SEC, 353 F.2d 905 (D.C. Cir. 1965).

_/ 41 Stat. 1063 (June 10, 1920). Pub. L. No. 280.

later, the Natural Gas Act of 1938, _/ also administered by the Federal Power Commission, extended federal regulation to the interstate operations of natural gas pipelines.

A number of utility holding company characteristics frustrated effective state regulation prior to passage of the Act. One device frequently used by holding company systems to inflate operating expenses or asset values to the detriment of the consumer involved contracts for management, construction, or supplies between the operating utility and another company within the same system. While these contracts were frequently performed at inflated costs to the utility, state regulators did not have access to the books and records of an out-of-state affiliate to disprove their reasonableness. Lack of uniform accounting standards also led to the inclusion of abritrarily written-up asset values in the rate base. Also, the far-flung utility holding company empires effectively removed control of the operating utilities from the kind of local management Congress deemed most sensitive and responsive to local needs and concerns with respect to the operating utilities, given their essentially local nature at that time.

The Commission does not believe that the holding company abuses which frustrated effective state regulation or otherwise adversely affected consumers will recur. In part, the Commission's conclusion is based on the extensive reorganization of the industry which occurred under Section 11. However, it is also based on the tremendous increase since 1935 in the

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_/ 15 U.S.C. 717 et seq.

effective regulation of electric and gas utilities at both the federal and the state level.

1. Federal Regulation of Electric and Gas Utilities

The Federal Power Act and the Natural Gas Act, both administered by the Federal Energy Regulatory Commission, establish comprehensive schemes for federal regulation of all aspects of the interstate transmission and sale of electrical energy and natural gas, respectively. FERC is charged in administering these Acts with assuring maximum supply and continuity of utility service, as well as "just and reasonable rates" for wholesale sales of electric energy and gas. _/ In addition to wholesale rate regulation, these Acts provide for regulation of the construction, acquisition, or disposition of utility properties, the issuance of securities (where not subject to regulation at the state level), and affiliate transactions. FERC has established uniform systems of accounts under both Acts and is also authorized to require detailed information regarding utility finances and corporate structure to assure effective implementation of the Acts' substantive provisions. Provisions throughout both Acts require that regulatory determinations be made "in the public interest," which in this context would focus on the interests of energy consumers._/

_/ 16 U.S.C. 824d(a) and 15 U.S.C. 717c(a).

_/ See 15 U.S.C. 717(a); 16 U.S.C. 824(a); NAACP v. FPC, 425 U.S. 662, 666, 669-70 (1976).

Finally, both Acts provide for coordination and cooperation of federal regulatory efforts with those of the states.

Section 6 of the Natural Gas Act _/ and Section 208 of the Federal Power Act, _/ which are identical, authorize FERC to ascertain the cost of the property of every natural gas pipeline company or electric company subject to its jurisdiction, the depreciation associated with such property, and, when necessary for ratemaking purposes, other facts which bear on the determination of such cost or depreciation. FERC uses this authority to regulate transactions between such utilities and affiliated entities. It might be noted that FERC recently determined that it would be more appropriate to use a market test as the basis for determining the reasonableness of an affiliate supplier's price._/ Section 13 of the 1935 Act requires use of a "cost" standard in such transactions. Section 318 of the Federal Power Act _/ provides for deference to the Commission's jurisdiction under the 1935 Act when the 1935 Act and the Federal Power Act contain overlapping provisions. Thus, that portion of the industry represented by the registered holding company systems is now subject to a different federal standard for determining

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_/ 15 U.S.C. 717e.

_/ 16 U.S.C. 824g.

_/ Public Service Company of New Mexico, 10 FERC (DOE) ¶ 63,020 (Jan. 25, 1980). See Columbia Gulf Transmission Company, Dkt. No. RP75-105, Op. No. 47 (July 2, 1979), reh. denied, Op. No. 47-A (Dec. 20, 1979).

_/ 16 U.S.C. 825q.

affiliate transaction prices than that applied to the rest of the industry. Repeal of the 1935 Act would eliminate this difference. _/

2. State Regulation of Electric and Gas Utilities

Another factor in the Commission's decision to recommend repeal of the 1935 Act is the significant increase since 1935 in the effective reach of state utility regulation. One of the reasons underlying Congressional concern with the vast public utility holding companies of the 1920's and early 1930's was that their interstate activities were not susceptible to effective control by state regulators. The Commission recognizes that the states are still unable to regulate interstate utility holding companies directly in a comprehensive fashion, and that the pattern of state control over operating

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_/ There is no comparable provision in the Natural Gas Act which regulates the interstate gas pipelines. It should be noted that Section 305(b) of the Federal Power Act prohibits, unless authorized by order of the Federal Energy Regulatory Commission, officers and directors of a public utility from serving as officers and directors of banks, investment bankers, underwriters, and electrical equipment suppliers. In addition section 305(c) of that statute requires annual reporting of such interlocks, and defines certain terms (holding company, registered holding company and holding company system) by adopting their definitions in the 1935 Act. If the 1935 Act is repealed, these terms will have to be formally defined in the Federal Power Act.

utilities and their relationships with affiliates _/ remains uneven. However, state commissions today generally have far more practical experience and better resources with which to supervise public utilities than was the case in 1935.

A major factor in more effective regulation is the dramatic development of uniform and enforceable accounting standards noted above. Uniform accounting standards give state regulators a far more accurate, sophisticated, and useful understanding of intercorporate transactions, utility earnings, and investment and capital needs, than did the accounting standards that existed at the time the 1935 Act became law.

Another factor that has enhanced the effectiveness of state regulation is the historical role of the 1935 Act in restructuring the industry. The Commission has successfully dismantled the former complex utility conglomerates into the present integrated utility systems with simple capital structures, most of which are now either operating companies or exempt holding companies. This simplification has permitted the states to exercise greater control over utility companies operating within their jurisdiction.

_/ In this section, the term "affiliate" is used in the ordinary sense of the word to mean a person or another company that has a significant relationship with the utility, usually through stock ownership, either directly or through a common parent company. The 1935 Act and state utility codes variously define the term.

The effective reach of state utility regulation has also considerably expanded as a result of judicial decisions handed down shortly before or after the 1935 Act became law. One was the 1932 Supreme Court decision in Western Distributing Co. v. Public Service Commission, 285 U.S. 119, in which the Court abolished the prior general rule that state regulators had the burden of disproving the reasonableness of contracts between a utility and its parent. Since that time, the state commissions have been able to require that utilities demonstrate the reasonableness of contractual and other operating and service costs, particularly when performed by affiliates. Another was the Supreme Court's 1937 decision in Natural Gas Pipeline Company v. Slattery, 302 U.S. 300, which upheld the authority of state regulators both to require access to the accounts and records of an affiliate that had engaged in transactions with a jurisdictional utility _/ and to require the submission of any necessary reports from the affiliate.

Thus, although states may not exercise direct regulatory powers over foreign utility holding companies, they are generally able to regulate the various relations and dealings between operating utility companies, their parent holding companies,

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_/ A utility company within the regulatory jurisdiction of a particular state public service commission is commonly known as a "jurisdictional utility."

and other affiliates. Following are some examples of state legislation which empower public service commissions to exercise such control.

a. Accounting and Reporting Requirements

Today, almost every state has adopted legislation requiring electric and gas utility companies to use a uniform system of accounts and prescribing or authorizing the state public service commission to prescribe applicable methods. _/ State law may also provide that utilities must keep separate accounts for non-utility businesses in which they engage and furnish those accounts to the state agency. _/ Many states also have special accounting and reporting requirements for transactions between the utility and affiliates. _/ In addition, they may require annual and other financial reports to disclose relationships with affiliates and business operations of the affiliates, _/ or the identity of corporate stockholders, and their officers and directors. _/ State utility commissions may also be

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_/ See, e.g., Ill Ann. Stat. Ch. 111 2/3 § 11 (Smith-Hurd 1977). The 1980 Annual Report of the National Association of Regulatory Utility Commissioners (hereinafter "NARUC 1980 Report") indicates that only Nebraska has no such authority. In practice, many states have adopted the FERC system of uniform accounts.

_/ See, e.g., D.C. Code Ann. § 43-509 (1981).

_/ NARUC 1980 Report at 525.

_/ See, e.g., Md. Ann. Code, Art. 78 §§ 67B, 67C.

_/ See, e.g., Ind. Code Ann. § 8-1-2-49(3) (Burns 1973).

authorized to require annual audits by independent accountants and/or to conduct such audits themselves. Some state agencies may even perform limited inspections of affiliate records._/

b. Prior approval of transactions with affiliates

In recognition of the possible unfairness involved when public utilities enter into business dealings with affiliates, states typically require prior approval of contracts with affiliates for supplies, management services, or construction. _/ In addition, prior state commission approval may be required for any loans _/ or financial contracts _/ between a public utility company and its affiliates. _/

State public service commissions also regulate transactions between the utility and its affiliates indirectly through their ratemaking authority. For example, state laws may control or

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_/ See, e.g., Mass. Ann. Laws, ch. 164 § 85 (Michie/Law. Co-op. 1979).

_/ See, e.g., 66 Pa. Cons. Stat. Ann. § 2102 (Purdon 1979) (West).

_/ See, e.g., N.J. Stat. Ann. § 48:3-7.2 (West 1969).

_/ See, e.g., Ill. Ann. Stat., Ch. 111 2/3 § 8a(3) (Smith-Hurd 1977).

_/ For that matter, the revenues from public utility operations may be restricted by state law to specified uses, all related to public utility operations. See, e.g., N. Y. Pub. Ser. Law § 107 (McKinney 1955).

limit borrowing by the utility from affiliates by limiting the inclusion of such interest expenses in the cost of service to those found to be "reasonable."_/ The commissions may disallow as a cost of service or from the rate base a portion of the amounts charged a utility in transactions with affiliates if the amount is either found to be above market cost, involves a rate of return to the affiliate deemed excessive, or is otherwise deemed unreasonable. State commissions may also allocate costs between an operating company and its affiliates._/

c. Financings and Capitalization

The issuance of securities by public utilities, including mortgage bonds, debentures, notes (over one year in maturity) and preferred and common stock, is now specifically regulated in most states. _/ Often the proceeds from the issuance of stock or debt are restricted to certain purposes related to utility operations and the amount of each issue is approved by the state commission. _/

_/ See, e.g., Texas Rev. Civ. Stat., Art. 1446c, § 41(c)(1) (Vernon 1980).

_/ See, e.g., N.Y. Pub. Ser. Law § 66(13) (McKinney 1955).

_/ NARUC 1980 Report at 520.

_/ See, e.g., Mich. Stat. Ann. § 22.101 (Callaghan 1970).

Irrespective of involvement by an affiliate, many states require express prior approval from the state regulatory commissions for any loan, guarantee or endorsement of indebtedness, or investment of funds by jurisdictional utilities, to assure that the operating utility is protected from any abusive lending or credit relationship. _/ States may also require prior regulatory approval for any sale, assignment, transfer, lease, mortgage, or other direct or indirect disposition or encumbrance of public utility property, franchises, or business._/

The utility's capitalization may be protected in part by restrictions concerning the payment of dividends by the utility. _/ The integrity of a utility's stated and actual capital may be also preserved by limitations on the capitalization of intangible assets, _/ the periodic revaluation of capital assets, _/ and requirements that capital impairments be made good. _/

_/ See, e.g., Mass. Ann. Laws, ch. 164, § 17A (Michie/Law. Co-op. 1979).

_/ See, e.g., Cal. Pub. Util. Code § 851 (West 1975).

_/ See, e.g., N.J. Stat. Ann. § 48: 2-29-1 (West 1969).

_/ See, e.g., Cal. Pub. Util. Code § 820 (West 1975).

_/ See, e.g., Ill. Ann. Stat., ch. 111 2/3 § 30 Smith-Hurd (1977).

_/ See, e.g., Mass. Ann. Laws, ch. 164 § 16 (Michie/Law. Coop. 1979).

d. Review of Major Corporate Changes

State utility commissions may be authorized to conduct advance reviews of mergers, reorganizations, or consolidations, _/ as well as of changes in control. _/ This type of state regulation conditions major corporate changes on prior state approval. Special examination of a public utility's capitalization may be required on such occasion to assure that fair value is paid for the company's stock and assets. _/

e. Conclusion

The Commission recognizes that not all states have in place comprehensive systems of utility regulation that include all of the above items. However, it seems clear that the states have the authority to enact such systems and it seems equally clear that a comprehensive state system is fully able to protect the financial integrity of a public utility operating within its jurisdiction to assure that neither utility revenues (other than reasonable and proper dividends), utility assets, or utility credit are used for non-utility purposes except in accordance with prescribed guidelines or following review and approval by the state regulators. The states also appear to have adequate authority to regulate transactions between the utility and its affiliates to prevent the type of overreaching

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_/ See, e.g., Mass. Ann. Laws, ch. 164 §§ 96, 97 (Michie/ Law. Co-op. 1979 & 1981 Supp.); N.Y. Pub. Serv. Law §69-a (McKinney 1955).

_/ See, e.g., Cal. Pub. Util. Code § 854 (West 1975).

_/ See, e.g., N.Y. Pub. Serv. Law § 69-a (McKinney 1955).

that characterized so many holding company systems prior to 1935.

These transactions are already regulated at the state level for operating companies and exempt holding companies without the additional substantive regulation under the 1935 Act. While the state regulators probably would not be able to exercise the same type of direct regulation of an out-of-state parent holding company that the Commission does under the 1935 Act, the Commission believes that state regulation nonetheless could assure continued protection of consumers through comprehensive regulatory authority over the operating utilities and their transactions with affiliated entities.

V. THE 1935 ACT AND DIVERSIFICATION

The Commission is aware that a primary reason for much industry support for amendment or repeal of the 1935 Act is the interest many utilities have in using a holding company structure to diversify into non-utility businesses. The Act places some limits on such diversification through a holding company structure, and there is no other federal law that directly duplicates these restrictions. Potential elimination of such restrictions has caused some opponents of amendment or repeal of the Act to charge that such action would allow public utilities to reorganize into holding companies and thereby "escape" state regulation of diversification.

The Commission is sensitive to concerns that diversification might injure consumers or investors. Nevertheless, while the precise effects of diversification cannot be anticipated, partly because diversified activities vary greatly in magnitude and type, successful examples of highly diversified companies provide support for the industry's position. One such company is Citizens Utilities Co. which supplies electric, gas, telephone, water and wastewater services in more than 500 communities across the United States. Another example is General Telephone & Electronics Corp. which, aside from its telephone operations, markets many different telecommunications products. Tenneco Inc. is another successfully diversified company dealing in natural gas, petrochemicals, construction and farm equipment, and shipbuilding. Tenneco also has interests in insurance and banking.

The 1935 Act does not, of course, impose any restrictions or limitations on investment in non-utility businesses by operating electric or retail gas utilities that are not part of any holding company systems. Nor does the Act impose any limitations whatsoever on diversification by gas pipeline companies unless they are part of a system registered or exempt under the 1935 Act.

Diversification outside the utility industry was not a major concern when the 1935 Act was passed. Divestiture of unrelated businesses and the requirement of prior Commission approval for the acquisition of new non-utility interests by a registered system was rather a necessary adjunct to the Commission's primary mandate of reorganizing and simplifying the industry. Limitations on non-utility business activity by registered systems also reflected the prevalent view that the inherent stability, security, and profitability of the gas and electric industry was so great that almost any other type of investment was speculative by comparison and could only harm investors and consumers.

The utility business has changed significantly since that time and is now experiencing serious financial difficulties. The Commission is not in a position either to endorse or refute the industry's arguments that non-utility diversification is essential to its future financial health. Even if Congress should decide, however, that diversification is undesirable, the Commission does not believe it is necessary or desirable to retain the 1935 Act's detailed and comprehensive regulatory structure simply because it now serves to restrict the non-utility activities of holding companies.

This section of the Commission's statement explains the extent to which non-utility diversification is permitted under the Act by both registered and exempt holding companies, identifies the reasons limitations on such diversification were originally included in the Act, and summarizes the reasons why such concerns do not appear to justify continued retention of the Act's regulatory structure.

A. Limitations on Holding Company Diversification under the 1935 Act

The 1935 Act unquestionably limits the ability of both registered and exempt holding companies to diversify into non-utility businesses, although the restrictions are much more stringent for registered systems.

Section 11 of the Act requires that non-utility businesses of registered systems to be limited to those which are "reasonably incidental, or economically necessary or appropriate to the operations of [an] integrated public utility system." This requirement is often referred to as the "functional relationship" test. _/ Section 11 further requires that the Commission find that retention of an interest in a non-utility business be "necessary and appropriate in the public interest or for the protection of investors or consumers and not detrimental to the functioning of such system or systems." The Commission is authorized to require that registered systems divest any non-utility businesses that fail to meet the "functional relationship" standard of Section 11.

Sections 9 and 10 of the Act apply to new acquisitions by registered systems and require prior Commission approval of all such transactions. Because Section 10 prohibits Commission approval of any acquisitions deemed detrimental to the carrying out of the provisions of Section 11, new acquisitions of non-utility businesses are precluded unless they meet the "functional relationship" test.

_/ See Michigan Consolidated Gas Co. v. SEC, 444 F.2d 913, 917 (D.C. Cir. 1971).

Although the restrictions on non-utility businesses in Section 11 and Sections 9 and 10 apply only to registered systems, those provisions raise questions as to the extent to which exempt holding companies can diversify into non-utility businesses without losing their exemptions through Commission action under the "unless and except" clause of Section 3. _/

In two cases decided together in 1973, _/ a four-member Commission agreed that the Section 11 restrictions on non-utility investments did not apply to exempt holding companies but also concluded that the "unless and except" clause placed some limits on diversification by those companies. In those decisions, Commissioners Owens and Herlong would have required restrictions very close to those imposed on registered systems, thus requiring divestiture of interests such as agriculture and real estate, as well as finance and leasing activities. Chairman Casey and Commissioner Loomis would have permitted retention of unrelated investments subject to the following five guidelines:

1. Non-utility activities must be separated from utility activites in separate corporate subsidiaries.
2. No service, materials, or other contracts are permitted between the utility and the other subsidiaries unless subject to supervision by state regulators.

_/ If the Commission revoked or denied their exemptions, such holding companies would be required to register and then could be required under Section 11 to divest themselves of those businesses or properties had no "functional relationship" to their utility operations.

_/ In Re Pacific Lighting Corp., 45 SEC 152 (1973) and In Re National Utilities & Industries Corp., 45 SEC 167 (1973).

3. No use of utility operating management, funds or credit is permitted for non-utility purposes.

4. Non-utility investments, both individually and in the aggregate, must be a relatively small part of the system.
5. Non-utility businesses must either significantly complement the utility business or have established and successful records.

Chairman Casey and Commissioner Loomis concluded that the non-utility investments in these cases conformed to these guidelines and would have permitted the companies to retain their exemptions. The effect of the 2-2 split was to permit the existing exemptions to continue.

Although the Commission has not revisited this issue since 1973, it has not sought to revoke or deny any Section 3(a) exemptions on the grounds of non-utility investments. While the Commission continues to believe that it has the authority to take such action, such issues would generally not be raised unless the non-utility investments either posed a threat to the financial integrity of the utility system or resulted in a system that was no longer primarily in the utility business. _/

In administering the Act's provisions relating to the retention or acquisition of "functionally related" non-utility businesses, the Commission has determined that acquisitions related to the utility's fuel supply -- such as coal mines for electric utilities, oil and gas exploration ventures, and fuel

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_/ See In Re Lykes Bros. Inc., Public Utility Holding Company Act of 1935 Release No. 20487 (April 6, 1978), 14 SEC Docket 672 (April 18, 1978).

transportation facilities -- satisfy the statutory standards. Such acquisitions, however, must be primarily for the use of the system's utility operations and not for sale to others. Areas found by the Commission not to meet the "functional relationship" test have included land development, housing construction, electric instruments, pulpwood, textiles, buses, street railways, as well as ice and telephone companies.

B. Role of Non-Utility Diversification in Passage of the 1935 Act

Because no other federal statute directly duplicates the restrictions on non-utility investments imposed by the 1935 Act, the Commission has sought to identify why such limitations were included by Congress.

As noted, passage of the 1935 Act was preceded by an exhaustive Federal Trade Commission study _/ of the public utility industry that has been referred to as "the most thoroughgoing investigation of an American industry that has ever appeared." _/ The House Interstate and Foreign Commerce Committee also conducted a separate investigation, resulting in a 6-volume report. _/ The Supreme Court has referred to these two reports as "some of the most exhaustive and comprehensive studies ever to underlie a federal statute." _/ Both clearly identified

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_/ FTC Report, supra note ___.

_/ Barnes, supra note __ at 71 n.8.

_/ Splawn Report, supra note ___.

_/ North American Company v. SEC, 327 U.S. 686, 701 n.11 (1946).

numerous and complex abuses attributable to the aggregation of control of electric and gas utilities in vast holding company systems. However, while the acquisition of non-utility businesses by such systems was noted, it was not linked to any abuses other than those arising out of utility transactions with affiliates. The term "diversification" as used in these reports refers to the alleged diversification of risk obtained when holding companies owned geographically scattered and unintegrated utility properties -- not to utility holding company acquisitions of non-utility businesses.

Nonetheless, the 1935 Act expressly limits registered holding company systems to non-utility businesses that are functionally related to the operations of an integrated public utility system. Concern over such investments is found in other portions of the Act's legislative history. For example, in its report to the Congress, the National Power Policy Committee _/ stated:

> "Holding companies should be restricted as soon as practicable to the business of operating and owning the securities of public-utility properties; they should not be permitted to engage in nonutility or speculative ventures." _/

There appear to be two reasons for this point of view and for the Act's limitations in Section 11 on retention of non-

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_/ See supra note __ (p. 37).

_/ S. Rep. No. 621, 74th Cong., 1st Sess. 59 (1935).

utility investments by registered holding company systems. First, elimination of many non-utility holdings was necessary to achieve the overriding purpose of the Act -- reorganization of the holding company empires to reduce utility systems to a size that corresponded to the essentially local nature of gas and electric utilities at that time and that would permit effective regulation of utility operations at the state level. As stated in the Senate Report, one of the purposes of Section 11 was

> "to confine the operations and the interest of each public utility system to the actual utility business of a given region so that the system will have to work out a modus vivendi with the population of that region." _/

Restoration of utility operations to local control and management was facilitated by the requirement that the parent holding company limit its interests in non-utility businesses to those related to that integrated utility system.

Second, commentary on non-utility investments in the Act's legislative history invariably refers to the speculative nature of such investments. The most significant instance where utility and non-utility operations were combined was in the Cities Service holding company system. _/ That system controlled some 65 public utility companies in 20 states and Canada, plus some 45 additional companies that were engaged in

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_/ S. Rep. No. 621, 74th Cong., 1st Sess. 11 (1935).

_/ In Re Cities Service Co., 8 SEC 318 (1940).

the oil business. Oil production was then regarded as highly speculative, in sharp contrast to the security, stability, and profitability of the gas and electric utility business. It was felt that investors who thought they were buying utility securities in such cases would be seriously misled as to the true character of their investment and its inherent risks. Furthermore, it was thought that the more speculative nature of non-utility businesses meant that investors could only be injured -- never benefited -- by such investments. _/ The resultant injury to the utility's credit could only cause the costs of capital to increase, thereby also injuring the consumer through higher rates.

C. Changes in the Industry

These views were all premised on a highly stable and profitable electric and retail gas utility industry. This was an accurate description until relatively recently. Even in 1972, the National Association of Regulatory Utility Commissioners could report with respect to electric utilities:

> "[T]here is no problem of a slackening in demand for electric service or the emergence of significant competitors of the existing electric power industry. Indeed, the converse is the case. Demand is growing more rapidly than the capacity of the industry to supply it, and more uses for electricity are being uncovered each day.... Considering trends in

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_/ Hearings before the Securities Subcommittee of the Committee on Interstate and Foreign Commerce, "Study of Operations Pursuant to the Public Utility Holding Company Act of 1935," 79th Cong., 2d Sess. 948-49 (1946) (testimony of Milton Cohen).

> demand, costs, technology and competition, it is safe to conclude that for the indefinite future the electric power industry, in substantially its present form, will continue to be a vital and growing industry...."_/

The financial situation of the industry has changed dramatically since that report. Inflation, the high cost of fuel, overcapacity, and a declining growth rate have created financial problems for the utilities. Rates have moved steadily upward, but most utilities are still not earning their allowed rates of return. Bonds have been downrated and the common stocks of most utilities have been selling below book value for some time. These factors indicate that utilities are not now the stable and profitable investment that they were in 1935 or even 10 years ago. Thus, the argument that any move by a utility into another business necessarily increases the risk of the total enterprise no longer has the same validity. In contrast today, there seems to be a good chance that the new business may prove less "risky" or more profitable than the utility. In any event, the financial reporting and disclosure requirements of the Securities Acts should assure that investors have every opportunity to determine accurately the type of business engaged in by the companies that offer securities to the public.

_/ 1972 Report of the Ad Hoc Committee on Non-Utility Investments - Diversification by Utility Companies, National Association of Regulatory Utility Commissioners, at 10.

For these reasons, the Commission does not believe it appropriate to retain the 1935 Act merely for the purpose of inhibiting or restricting non-utility investments by utility holding companies or because the Act may deter take-overs of utilities by conglomerates. Neither of these concerns was central to Congress' thinking when the Act was passed in 1935. They do not justify retention of a statute that imposes continuing substantive regulatory burdens on a relatively small portion of the industry long after its basic purpose has been accomplished and the abuses which the Act was intended to correct have been eradicated.

V. CONCLUSION

For the foregoing reasons -- the completion of the Commission's basic task under the Act and significant changes since 1935 in the economic and regulatory climate affecting electric and retail gas utilities -- the Commission recommends that Congress repeal the 1935 Act.

APPENDIX A

OUTLINE OF MAJOR PROVISIONS OF PENDING BILLS TO AMEND THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

S. 1871: This bill would amend the definition of the term "public utility company" in Section 2(a)(5) to exclude gas companies that either own or operate only facilities for the retail distribution of gas within a single state or whose interstate rates are subject to regulation by the authorities of one state or of contiguous states. The proposal would make this exception available only if every company that controlled, directly or indirectly, the gas utility company had a class of securities registered under the Securities Exchange Act of 1934 and was thus subject to the financial reporting and other provisions of that Act. The three currently registered gas utility holding companies meet these standards and thus would be removed from the Act's jurisdiction if this bill were enacted.

S. 1878 and H.R. 5220: These two bills would both amend Section 3 of the 1935 Act to entitle two additional categories of holding companies to exemption. More significantly, these proposals would require the Commission to grant unqualified exemptions from all provisions of the Act, other than Section 9(a)(2) (which concerns acquisitions where the acquirer is or would become an an affiliate of more than one electric or retail gas public utility company). This would be accomplished by eliminating "unless and except" clause in the present statute that permits the Commission to revoke or deny an exemption if it is detrimental to the public interest or to the interests of investors or consumers. This would effectively repeal the 1935 Act for any holding company meeting the current or proposed standards for exemption. H.R. 5220 would also add a new subsection (f) to Section 3 to require that any non-utility business of a holding company exempt under Section 3(a) be conducted through a separate non-utility subsidiary.

S. 1869: This bill would make major amendments in the provisions of the Act relating to financings, non-utility acquisitions, retention of gas utility properties, and affiliate transactions. Some of the most significant changes include:

- Elimination of Commission jurisdiction over most financings and alteration of the standards for approving the financings that remain under Commission jurisdiction. The proposed changes include permitting filings for financings to become effective automatically unless affirmative action is taken by the Commission and providing that any such action be based on an "unsound financial practice," a new term defined in S.1869. These changes would constitute a considerable circumscription of the current qualitative standards for approving financings by registered public utility holding company systems.

- Elimination of the current requirement for prior Commission approval of the acquisition of non-utility businesses and alteration of the standards pursuant to which divestiture of such businesses could be required. Under this proposal, the Commission could require divestiture where both the non-utility business was found to be "material" and its continued retention found detrimental to investors or consumers. As a practical matter, the Commission might be able to force divestiture under these standards only if the business were relatively large and losing money and the utility system faced a financial crisis.
- Ability of three of the registered electric systems to retain their relatively minor gas operations would be assured.
- Elimination of Commission regulatory authority over a number of transactions between companies within the same registered system where the transactions are expressly authorized by the relevant state commission.
- Alteration of the present "cost" standard for contracts with affiliates to permit performance at a price equal to or less than the market price of comparable goods or services.

APPENDIX B

SECTION BY SECTION ANALYSIS OF THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

NECESSITY FOR CONTROL OF HOLDING COMPANIES

Section 1

Section 1 recites the need to control public-utility holding companies, lists a group of evils and abuses that adversely affected the national public interest, the interest of investors and the interest of consumers, and declares that the act's policy shall be "to meet the problems and eliminate the evils as enumerated in this section."

DEFINITIONS

Section 2

Section 2(a) sets forth the definitions under the act. Section 2(b) contains provisions for declaring a "person," rather than a "company," to be a holding company, subsidiary company or an affiliate under the act. Section 2(c) provides that the act shall not apply to Federal or state agencies, authorities, corporations or instrumentalities. The more important of the definitions are as follows:

"Holding company," defined in section 2(a)(7)(A) as one "which directly or indirectly owns, controls or holds with power to vote, 10 per centum or more of the outstanding voting securities of a public-utility company;"

"Public-utility company," defined in section 2(a)(5) as "an electric utility company or a gas utility company;"

"Electric utility company," defined in section 2(a)(3) as one "which owns or operates facilities used for the generation, transmission, or distribution of electric energy for sale;"

"Gas utility company," defined in section 2(a)(4) as one "which owns or operates facilities used for the distribution at retail . . . of natural or manufactured gas for heat, light and power;"

"Utility assets," defined in section 2(a)(18) as "the facilities, in place, of any electric utility company or gas utility company for the production, transmission, transportation, or distribution of electric energy or natural or manufactured gas;" and

"Integrated public-utility system," defined in section 2(a)(29)(A) for an electric system and in section 2(a)(29)(B) for a gas system, both such definitions being concerned with the physical interconnection and coordinated operation of utility properties in a single area or region.

EXEMPTIONS

Section 3

Section 3(a) of the act provides that the Commission shall exempt certain specified types of holding company systems from the act "unless and except insofar as it finds the exemption detrimental to the public interest or the interest of investors or consumers." This is known as the "unless and except" clause. The types of holding companies which qualify for this exemption are:

(1) the predominantly intrastate holding company system, where the holding company and all its public utility subsidiaries are all organized and carry on their business in substantially one state;

(2) the system whose holding company is predominantly an operating public-utility company whose utility operations do not extend beyond the state in which it is organized and states contiguous thereto;

(3) the company which is only incidentally a holding company, being primarily engaged in another business;

(4) the temporary holding company, which has become such through the acquisition of securities for liquidation or distribution in connection with a debt or arrangement for underwriting or distributing the securities; and

(5) the holding company with no domestic public-utility subsidiaries.

Section 3(b) concerns exemptions from the act for certain foreign subsidiaries of a holding company. Section 3(c) provides that the Commission shall revoke an exemptive order issued under section 3(a) or 3(b) when it "finds that the circumstances which gave rise to the issuance of such order no longer exist." Section 3(d) provides that the Commission may by rule exempt from some or all provisions of the act, conditionally or unconditionally, any class or classes of persons from the duties and obligations imposed upon them as subsidiary companies or affiliates.

TRANSACTIONS BY UNREGISTERED HOLDING COMPANIES AND REGISTRATION OF HOLDING COMPANIES

Sections 4 and 5

Section 5 provides for the registration of holding companies under the act. Unless a holding company applies for an exemption pursuant to section 3(a), or registers under section 5(a), then section 4(a) makes it unlawful for such holding company, directly or indirectly, to engage in various activities in interstate commerce, including owning securities of a subsidiary that is engaged in such activities.

FINANCINGS

Section 6

Section 6(a) provides that unless the Commission permits a declaration to become effective under section 7, it shall be unlawful for any registered holding company or subsidiary thereof to (a) issue or sell any security of such company, or (b) exercise any privilege or right to alter the priorities, preferences, voting power, or other rights of the holders of an outstanding security of such company. Section 6(b) provides certain exemptions from the provisions of section 6(a). Among such exemptions is one for the issuance and sale of short-term debt (not to exceed 5% of the issuer's capitalization), and another under which the Commission shall exempt, subject to such terms and conditions as it deems appropriate, the issuance and sale of securities by a subsidiary of a registered holding company if the purpose is solely for financing the business of the subsidiary and it has been expressly authorized by the State commission of the State in which such subsidiary is organized and doing business.

Section 6(c) makes it unlawful for a registered holding company or subsidiary thereof, directly or indirectly, to (1) engage in house-to-house sales of any security of the holding company, or (2) have any officer or employee of any subsidiary of such holding company sell any security of the holding company.

Section 7

Section 7 contains the standards for the issue or sale of a security by a registered holding company or subsidiary thereof. Generally, the security must be either --

(a) a common stock having a par value and being without preference as to dividends over, and having at least equal voting rights with, any outstanding security of the issuer; or

(b) a bond secured by a first lien on the physical property of the issuer; or

(c) a guaranty of, or assumption of liability on, a security of another company; or

(d) is to be issued or sold solely for the purpose of refunding a security of the issuer or for the purpose of effecting a merger, consolidation, or other reorganization; or

(e) is to be issued or sold solely for the purpose of financing the business of the issuer as a public-utility company; or

(f) is to be issued or sold solely for the purpose of financing the business of the issuer when it is neither a holding company nor a public-utility company; or

(g) is to be issued or sold for necessary and urgent corporate purposes of the issuer when the requirements of issuing a common stock or first lien mortgage bond would impose an unreasonable financial burden on the issuer.

In addition, under section 7(d) the Commission may not permit the issue of sale of a security if it finds that:

(a) the security is not reasonably adapted to the security structure of the issuer and other companies in the same holding company system; or

(b) the security is not reasonably adapted to the earning power of the issuer; or

(c) the financing by the issue and sale of the particular security is not necessary or appropriate to the economical and efficient operations of a business in which the issuer lawfully is engaged or has an interest; or

(d) the fees and commissions with respect to such issue or sale are not reasonable; or

(e) with respect to a security that is a guaranty of a security of another company, the circumstances are such as to constitute the making of such guaranty an improper risk; or

(f) the terms and conditions of the issue and sale of the security are detrimental to the public interest or the interest of investors or consumers.

In addition, section 7(g) provides that applicable state laws must also be complied with.

COMBINATION GAS AND ELECTRIC COMPANIES UNDER STATE LAW

Section 8

Section 8 is concerned with the impact of state laws (dealing with the combined operation within the same area of electric and gas utilities by a single company or companies owned by one company) on acquisitions by registered holding companies and their subsidiaries of interests in electric and gas utilities. It makes it unlawful, if state law prohibits or requires approval or authorization of combination gas and electric utility companies, for a registered holding company or subsidiary thereof (1) to take any step resulting in its having an interest in a gas utility company and an electric utility company serving substantially the same territory without state approval, or (2) if it already has such an interest, to acquire an interest in either a gas or electric utility serving substantially the same area as that served by the such companies in which it already has an interest without state approval.

ACQUISITIONS

Section 9

Section 9(a) provides that unless the acquisition has been approved by the Commission under section 10, it shall be unlawful --

(1) for any registered holding company or subsidiary thereof to acquire, directly or indirectly, any securities or utility assets or any other interest in any business;

(2) for any person to acquire, directly or indirectly, any security of a public-utility company, if he is an affiliate under section 2(a)(11)(A) of such company and any other public-utility or holding company, or will as a result of the acquisition become such an affiliate. Section 2(a)(11)(A) defines an affiliate of a specified company as "any person that directly or indirectly owns, controls, or holds with power to vote, 5 per centum or more of the outstanding voting securities of such specified company."

Section 9(b) provides two exemptions from the requirements of section 9(a). The first exempts an acquisition by a public-utility company of utility assets the acquisition of which has been expressly authorized by a State commission. The second exempts an acquisitions by a public-utility company of securities of its subsidiary public-utility company provided both companies are organized in the same State, the business of each is substantially confined to such State, and the acquisition has been expressly authorized by the State commission of such State.

Section 9(c) exempts from the requirements of section 9(a) the acquisition by a registered holding company or subsidiary thereof of (1) securities issued or securities guaranteed by the United States or a State, or related entities, (2) certain other securities, primarily short-term obligations, that the Commission may by rule or regulation prescribe as appropriate and as not detrimental to the public interest or the interest of investors and consumers.

Section 10

Section 10 contains the standards which must be found by the Commission before it may grant an application (1) under section 9(a)(1) by a registered holding company or subsidiary thereof with respect to the acquisition of securities, utility assets, or any other interest in any business, and (2) under section 9(a)(2) by any person to acquire public-utility securities when such person is or will become an affiliate of the company whose securities are acquired and of any other public-utility or holding company.

Section 10(a) sets forth the kinds of information required in the application, and Section 10(d) prescribes the procedures for processing the application. Section 10(b) provides that the Commission may not grant an application if it finds that --

(a) the acquisition will tend toward interlocking relationships or concentration of control of publicl-utility companies of a kind or to an extent detrimental to the public interest or the interest of investors or consumers; or

(b) the consideration, including all fees, commissions, and other renumeration is not reasonable or does not bear a fair relation to the sums invested in or the earning capacity of the utility assets to be acquired or the utility assets underlying the securities to be acquired; or

(c) the acquisition will unduly complicate the capital structure of the holding company system or be detrimental to the public interest or the interest of investors or consumers or the proper functioning of such holding company system.

Section 10(c) provides that the Commission shall not approve--

(a) an acquisition of securities, utility assets or any other interest which is detrimental to the carrying out of the provisions of section 11 (which concerns the simplification of holding company systems), or would evade state limitations on combination electric and gas service; or

(b) the acquisition of securities or utility assets of a public-utility or holding company unless it finds the acquisition will serve the public interest by tending toward the economical and efficient development of an integrated public-utility system.

Section 10(e) provides that the Commission may prescribe such terms and conditions with respect to the acquisition of securities or utility assets, including the price to be paid, as it may find necessary or appropriate. Section 10(f) requires that the Commission not approve an acquisition under section 10 unless there has been compliance with applicable State law (unless compliance with such law would be detrimental to the carrying out of the provisions of section 11).

INTEGRATION AND SIMPLIFICATION OF HOLDING-COMPANY SYSTEMS

Section 11

Section 11 contains the basic integration and corporate simplification requirements under the act. Section 11(b)(1) makes it the duty of the Commission to require each registered holding company and subsidiary thereof take such action as the Commission finds necessary to limit its holding-company system to a "single integrated public-utility system, and to such other businesses as are reasonably incidental, or economically necessary or appropriate to the operations of such integrated public-utility system." These limitations are also incorporated by reference into section 10(c) supra to govern acquisitions.

An integrated public-utility system is defined in section 2(a)(29)(A) for an electric system and in section 2(a)(29)(B) for a gas system, both such definitions being concerned with the physical interconnection and coordinated operation of utility properties in a single area or region. An exception to the single integrated system limitation is found in the (A)-(B)-(C) clauses of section 11(b)(1), under which one or more additional integrated systems may be retained by a registered holding company if the Commission finds that --

(a) each of the additional systems cannot be operated independently without loss of substantial economies;

(b) all such additional systems are located in one state, or in adjoining states, or in a contiguous foreign country; and

(c) the combination of systems is not so large as to impair the advantages of localized management, efficient operation, or the effectiveness of regulation.

Section 11(b)(2) provides that the Commission shall require each registered holding company and each subsidiary thereof to take such steps as may be necessary to insure that the corporate structure or continued existence of any company in the holding-company system does not unduly or unnecessarily complicate the structure, or unfairly or inequitably distribute voting power among security holders, of such holding-company system . It also provides that there shall be not more than two tiers of holding companies over an operating public-utility company.

Section 11(c) contains provisions concerning compliance with Commission orders under section 11(b). Section 11(d) provides that the Commission may apply to a court, in accordance with the provisions of section 18(f), to enforce compliance with an order issued under section 11(b). Section 11(e) provides that a registered holding company or subsidiary thereof may submit a plan for compliance with the provisions of section 11(b), sets forth the standards for Commission approval of such plan, and provides the Commission may apply to a court to enforce and carry out the provisions of such plan. Section 11(f) provides that in Federal court proceedings for reorganization of a registered holding company or subsidiary thereof, plans of reorganization must be approved by the Commission, after opportunity for hearing, prior to submission in court; and that the Commission may require its approval of fees and expenses in connection with any proceeding. Section 11(g) contains provisions concerning the solicitation of proxies concerning any reorganization plan or plan for divesting control, securities or assets, or plan for the dissolution of any registered holding company or subsidiary thereof.

AFFILIATE TRANSACTIONS

Section 12

Section 12(a) prohibits a holding company from borrowing or receiving any extension of credit or indemnity from any public-utility company in the same holding-company system or from any of its subsidiaries.

Section 12(b)-(g) subject certain intra-system transactions to regulation by declaring them unlawful if in contravention of the Commission's rules, regulations or orders. In general the Commission's rules require that authorization be obtained for significant departures from the statutory prohibitions summarized below:

(1) no registered holding company or subsidiary thereof may lend or in any manner extend its credit to or indemnify any company in the same holding company system (section 12(b));

(2) no registered holding company or subsidiary thereof may declare a dividend out of capital surplus or acquire any of its securities (section 12(c));

(3) no registered holding company may sell any security which it owns of any public-utility company or any utility assets (section 12(d));

(4) no solicitation of the stockholders with respect to any security of a registered holding company or subsidiary thereof may be effected (section 12(e)); and

(5) no other transaction between affiliates in a registered holding company system may be effected (sections 12(f) and 12(g)).

Section 12(h) makes it unlawful for any registered holding company or subsidiary to make any contribution in connection with the candidacy, nomination, election or appointment of any person for or to any office in the United States, a State or any political subdivision of a State, or to make any contribution to or in support of any political party or any committee or agency thereof. It should be noted that the prohibition in section 12(h) against certain contributions with respect to Federal elective offices was eliminated by enactment of the Federal Election Campaign Act Amendments of 1976 (Pub. L. No. 94-283, May 11, 1976). Section 321(b)(2)(c) of that statute (codified at 2 USC §441b(b)(2)(C)) created a specific exclusion from the term "contribution" in section 12(h) of the 1935 Act for "the establishment, administration, and solicitation of contributions to a separate segregated fund to be utilized for political purposes by a corporation . . ."

Section 12(i) makes it unlawful for any person employed or retained by any registered holding company or subsidiary thereof to advocate any matter affecting any registered holding company or subsidiary thereof, before the Congress or any memeber or committee thereof, or before the Securities and Commission or the Federal Power Commission (now Federal Energy Regulatory Commission), unless such person files a report with the Securities and Exchange Commission with respect to such activity.

Section 13

Section 13 of the Act governs the activities of service companies. Section 13(a) generally prohibits a registered holding company from acting as a service company. Section 13(b) prohibits the entry into or performance of any intrasystem service, sales or construction contracts except in accordance with the terms and conditions as the Commission may prescribe by rules, regulations or order as necessary and appropriate "to insure that such contracts are performed for the benefit of such associate companies at cost, fairly and equitably allocated among such companies." The Commission may, by rule or order, exempt transactions from this requirement, principally if such transactions "involve special or unusual circumstances or are not in the ordinary course of business."

Section 13(c) authorizes the Commission to prescribe by rule or order terms and conditions concerning the determination of costs and their allocation, the duration of contracts, the making and keeping of accounts and cost accounting procedures, and the filing of reports.

Section 13(d) contains the standards under which the Commission shall approve any service company. In general it requires that such company be so organized "to insure the efficient and economical performance of service, sales, or construction contracts by such company for member companies, at cost fairly and equitably allocated among such member companies, at a reasonable saving to member companies over the cost to such companies of comparable contracts performed by independent persons."

Sections 13(e) and 13(f) contain provisions making it unlawful for any affiliate of a public-utility company and for any person principally engaged in the performance of service, sales or construction contracs for public-utility or holding companies (even though such affiliate or person is not a part of a registered holding company system), to enter into or perform certain contracts in contravention of the rules, regulations and orders the Commission may have regarding such subjects.

Section 13(g) provides that the Commission shall from time to time conduct investigations with respect to service, sales and construction contracts in the utility industry, and make reports to Congress, together with such recommendations as it deems advisable.

REPORTS, ACCOUNTS AND RECORDS

Section 14

Section 14 provides that the Commission may by rules, regulations or order require that every registered holding company and mutual service company file such annual, quarterly and other periodic and special reports, in such form and detail and with such information as to various matters, as the Commission may prescribe.

Section 15

Section 15 provides, generally, that every registered holding company and every subsidiary thereof shall make, keep and preserve for such periods such accounts and records as the Commission deems necessary. It also provides that the Commission may by rule or regulation prescribe uniform methods for keeping accounts required under the section, and that all books, accounts and records required to be kept shall be subject to examination by the Commission.

LIABILITY FOR MISLEADING STATEMENTS

Section 16

Section 16(a) imposes the civil liability of section 18 of the Securities Exchange Act of 1934 in connection with false or misleading statements in any application, report, registration statement or document filed under any provision of the act or rule, regulation or order thereunder.

Section 16(b) provides that the rights and remedies under the act (except as provided in section 17(b)) shall be in addition to those that may exist under the Securities Act of 1933 or the Securities Exchange Act of 1934, or otherwise at law or in equity, but that no person may recover a total amount in excess of his actual damages.

OFFICERS AND DIRECTORS

Section 17

Sections 17(a) and (b) corresponds to sections 16(a) and (b) of the Securities Exchange Act of 1934, and cover transactions by officers and directors of registered holding companies in the securities of those companies and their subsidiaries.

Section 17(a) requires that reports be filed by every officer and director of a registered holding company of his beneficial ownership of securities of such registered holding company or subsidiary thereof, and reports of changes therein.

Section 17(b) provides, with certain exceptions, that any profit realized by such officer or director from transactions in a period of less than six months in securities of such company shall be recoverable by the company whose securities were the subject of the transaction. No remedy is available under section 17(b) if a remedy is given under section 16(b) of the Securities Act of 1934.

Section 17(c) provides that no registered holding company or subsidiary thereof shall have as an officer or director, any executive officer, director, partner, appointee or representative of any bank, trust company, investment banker, or banking association or firm, or of a corporation a majority of whose stock is owned by any bank, trust company, investment banker, or banking association or firm, except in cases as the Commission by rule or regulation permit.

ADMINISTRATIVE PROVISIONS

Section 18

Section 18 contains provisions dealing with investigations by the Commission, injunctions to prevent or stop violations of the act, and suits to enforce compliance with the act or any rule, regulation or order issued thereunder.

Section 19

Section 19 contains provisions dealing with hearings before the Commission. The Commission, by rule or regulation, is directed to admit as a party in any proceeding any interested State or state-related entity, and may admit as a party any representative of interested consumers or security holders, or any other person whose participation may be in the public interest or for the protection of investors and consumers.

Section 20

Section 20 contains provisions concerning the rule-making power of the Commission and its authority to issue orders. Among other things, it provides that orders "shall be issued only after opportunity for hearing" (section 20(c)).

Section 21

Section 21 declares that the act shall not affect rights or obligations under the securities laws, and preserves the jurisdiction of other Federal, state and local agencies "insofar as such jurisdiction does not conflict with [the Act"].

Section 22

Section 22 deals with information filed with the Commission and its availability to the public.

Section 23

Section 23 requires the Commission to report annually to the Congress concerning its work for the preceding year, including such recommendations for further legislation concerning the act as it may find advisable.

Section 24

Section 24 provides for court review of orders issued by the Commission by any party or person aggrieved thereby.

Section 25

Section 25 deals with the jurisdiction of Federal courts over civil and criminal actions under the act.

Section 26

Section 26 provides that contracts made in violation of the act, or of any rule, regulation or order issued thereunder, shall be void.

Section 27

Section 27(a) makes it unlawful for a person to cause to be done through another person anything which it would be unlawful for the first such person to do under the act or any rule, regulation or order thereunder. Section 27(b) makes it unlawful for any person to

Section 28

Section 28 makes it unlawful for any person in connection with the issue or sale of securities of a registered holding company or subsidiary thereof to represent that such security has been guaranteed, sponsored or recommended for investment by the United States or any agency or officer thereof.

Section 29

Section 29 provides for criminal penalties for certain willfull conduct in violation of the act or rules, regulations or orders thereunder.

Section 30

Section 30 authorizes and directs the Commission to make studies and investigations of public-utility companies and make public from time to time its recommendations as to the type and size of geographically and economically integrated systems which can best promote and harmonize the interests of the public, the investor, and the consumer. It also authorized and directed the Commission to make a study of investment trusts and companies, and report the results of its study and its recommendations to the Congress on or before January 4, 1937. The Commission's reports pursuant thereto became part of the findings referred to by the Congress in the Investment Advisors Act of 1940 and the Investment Company Act of 1940.

Section 31

Section 31 deals with employees of the Commission.

Section 32

Section 32 contains a "separability" provision.

Section 33

Section 33 gives the Act the short title of the "Public Utility Holding Company Act of 1935."

APPENDIX C

Statement of
Aaron Levy
Director, Division of Corporate Regulation
Securities and Exchange Commission
on the
Administration
of the
Public Utility Holding Company Act of 1935
Presented To
Subcommittee on Energy Conservation and Power
of the
House Committee on Energy and Commerce
(H.R. 5220, 5465, 6134)
June 9, 1982

Chairman Ottinger, I thank you for your invitation to testify before this subcommittee regarding the Public Utility Holding Company Act of 1935 (the "Act"). In your letter to SEC Chairman Shad, dated May 10, 1982, you indicated your interest in the key provisions of the Act, how they have been implemented or applied in the recent past and at present, with examples, and an explanation of the purpose to which these provisions have been applied. Your interest is only in the factual content of my testimony, without any opinion on whether the Act should be amended or repealed. I assure you, sir, that the statement I here present is in full accord with your request and intention.

Chairman Shad's statement relates the legislative background of the Act, its basic purpose as expressed in the geographic integration provisions of Section 11(b)(1) and the extensive reorganizations under the corporate simplification requirements of Section 11(b)(2). Pursuant thereto, many holding companies have been liquidated, underlying subsidiaries have been merged, recapitalized, sold or spun off as independent operating companies. All this was substantially accomplished by 1955.

There are now nine active electric and three gas utility holding-company systems registered under the Act. They have combined assets of about $60 billion and in 1981 had about $28 billion in revenues. They include 60 operating utility subsidiaries, gas and electric, with retail service areas across 24 states.

I

1. Regulation of security issues (Sections 6 and 7)

Sections 6 and 7 in general provide for Commission authorization of the issue and sale of securities by registered holding companies or their subsidiaries. A security is comprehensively defined in Section 2(a)(16) to include bonds, debentures, stock, a note, various types of certificates, and any instrument commonly known as a "security." It includes also a guaranty or assumption of liability of another company or a warrant or right to subscribe to a security. Sections 6 and 7 apply to short-term borrowing in excess of 5% of capitalization of the borrowing company. Commission authorization is also required for any modification or alteration of priorities, preferences, voting or other rights of any outstanding security of a company subject to the Act.

Section 7(c) specifies the kind of securities which may be issued by members of registered systems. Under Section 7(c)(1) common stock and first mortgage bonds are identified as the primary means of financing utility systems, but Section 7(c)(2) permits the Commission to authorize other forms of financing. The Commission has regularly authorized the issuance of operating company preferred stock, and, in suitable cases, financing by lease and revenue bonds. The issuance of holding company debt, for example, is limited under Section 7(c)(2)(D) to "necessary and urgent corporate purposes" and when other means of financing would impose unreasonable financial burdens.

Section 7(d) is concerned with the quality and cost of the securities to be issued. Section 7(d) requires (1) that the securities be reasonably related to the capital structure of the issuing company and the holding-company system and to earning power; (2) that the particular security be appropriate for the economical and efficient operation of the system's business; and (3) that the cost of financing be reasonable. In broad perspective each financing must fit the capital structure of the system and not prejudice future financing.

The experience of the 1930s showed that state regulation of the securities issued by subsidiaries was frustrated when such securities were issued to a holding company whose own unregulated capital structure thus became the effective capitalization of the system.

Section 1(b)(1) specifies that the public interest and the interest of investors and consumers are affected when "securities are issued without approval or consent of the States having jurisdiction over subsidiary public-utility companies...." It also notes the same adverse effects when securities are issued by public-utility subsidiaries under circumstances which subject them "to the burden of supporting an overcapitalized structure," thereby tending "to prevent voluntary rate reductions."

Using the reorganization powers to eliminate corporate complexities in the securities structure of the system, and aided by the standards of Section 7, the Commission effectively cleared away defaulted securities, including preferred stocks with dividends in arrears and holding-company debt. This opened the way for new common stock financing to create the balanced utility capital structures mandated by Section 7. In the process, the Commission developed, largely through a consensus, minimum essential protective provisions for first mortgage bonds and preferred stock. These were codified in statements of policy promulgated under the Act on February 16, 1956 (HCAR No. 13105, first mortgage bonds; HCAR No. 13106, preferred stock), about 20 years after passage of the Act.*

The aim of Sections 6 and 7 is a simple and prudent capitalization of the registered holding company and its subsidiaries.

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* Commission rules, notices and orders are initially published as Holding Company Act Release No.—— (HCAR No.——)

The general standards developed by the Commission for the operating utility is a maximum of 55% long-term debt, a minimum of 30% common equity, and about 10% preferred stock. These are general standards, not inflexible. For the holding company, which holds only common stocks of its subsidiaries, its permanent capital is common stock, which represents the consolidated common equity of its subsidiaries, that for 30% to 40% of their capital are dependent upon the holding company. It also issues short-term debt to provide common equity to its subsidiaries, pending permanent refinancing by periodic sales of common stock. This means that the capitalization of the public-utility subsidiaries and of the holding company must be constructed in light of their mutual needs and the interdependence upon one another.

Utility companies provide an essential service in their territories. They are not permitted to cope with adversity by curtailing or abandoning service. But their business involves a continuous and large scale replacement and improvement of expensive facilities, which require a frequent supply of new capital. Both at the state level and under the Act, great emphasis is placed on maintenance of conservative capital structures, which will tend to produce economies in cost of new capital, and in the hope or expectation that the utility's credit will not be cut off or seriously affected by a depressed economy.

2. Administration of Sections 6 and 7

Since the early 1960s the size and pace of financing of registered systems and of the industry as a whole has accelerated rapidly. The magnitude of this financing reflects the growth, almost entirely internal, of the physical facilities required to meet demand. The following statistics from the Federal Power Commission's annual consolidated report on all investor-owned electric utilities in the United States, indicate the magnitude of such growth:

	1951	1961	1971	1979**
		(in billions)		
Net utility plant	$ 16.6	$ 38.4	$ 82.3	$ 192.6
Electric revenues	5.2	10.6	22.3	72.9
*Sales to consumers KWH	263.1	544.9	1,149.4	1,604.9

* Excluding wholesale sales to purchasers for resale. It omits a significant amount of wholesale sales to municipal or cooperative retail systems.

** Latest published

Net utility plant is about the same as the amount of the outstanding debt and equity securities, including bank borrowings in anticipation of long-term or permanent financing. It includes construction work in progress, which has grown disproportionately as the time required to complete major additions has lengthened from a median of two or three to eight or ten years. The disproportionate growth of electric revenues in the 1970s reflects principally radical increases in fuel and capital costs, the latter including rising interest rates and inflation in cost of construction. In recent years much larger and more frequent offerings of securities were required, while volatile markets make the timing of offerings difficult and critical. The registered systems, gas and electric, are of course, an integral part of that growth, with the same dependence on the capital markets, as shown in the following table:

	October 1, 1980 through September 30, 1981 (billions)	October 1, 1981 through May 26, 1982 (billions)
Bonds	$ 1.74	$ 1.35
Long-Term Notes and/or debentures	0.53	1.11
Pollution Control Financings	0.27	0.22
Preferred Stock	0.28	0.27
Common Stock	0.78	0.34
Subtotal	$ 3.60	$ 3.29
Short-Term Debt	7.15	2.51
Total	$10.75	$ 5.80

The total of such financings was $8.2 billion in fiscal 1978; $6.5 billion in fiscal 1979; and $8.8 billion in fiscal 1980.

3. Competitive Bidding

Sections 7 sets the standards on the type and amount of security issues, to provide sound investment quality for these securities. The price at which they are to be sold, reflecting investment risks, and the cost to the issuing company are dependent on the securities markets and competitive bidding, as provided by Rule 50 adopted on April 8, 1941 (HCAR No. 2676). Rule 50 requires that public offerings of securities of members of registered systems be made on sealed bids pursuant to public invitation for proposals. The Rule permits the Commission to grant exceptions. An exception is inherent in an authorization to exchange securities for specific property or for a merger or tender offer. For the same reason, the Commission's authorization, in recent years, of dividend reinvestment plans and employees stock ownership plans included the necessary exception from Rule 50. Issuers and underwriters exploring the Eurodollar market have been advised that an exception would be available for such offerings.

The Commission has not been receptive to repeated proposals to abandon competitive bidding, either outright or by an indiscriminate grant of exceptions for security issues which are suitable for public offering under competitive bidding. In 1974, the effects of the fuel crisis, which fundamentally and adversely altered the major costs element in both gas and electric service, created demonstrably unsettled conditions in the market for utility stocks. On July 19, 1974 (HCAR No. 18504), the Commission proposed a six-month suspension on competitive bidding for issues of common stock of registered holding companies. The suspension became effective immediately when pending applications for exceptions were duly granted. The adoption of the proposal (HCAR No. 18646), set March 31, 1975 as the end of the suspension period. Public comments were received and hearings were held on whether it should be extended and whether competitive bidding for preferred stock or bonds should also be suspended.

After a thorough review of the subject, including the experience with negotiated offerings during the suspension period, the Commission declined to extend the suspension (HCAR No. 18898). Competitive bidding under Rule 50 remains in effect for most significant public offerings, subject to particular exceptions as the need therefor is shown.

4. The Budget Method of Authorization

Although Sections 6 and 7 are directed in terms to individual issues of securities, the statutory standard of a balanced capital structure has always required a broader perspective. A bond issue, *ipso facto*, increases the debt ratio, while a stock issue decreases it, and the effect of short-term borrowing depends on how it is to be repaid. Any particular transaction has to be put into the context of the issuer's total capital requirements and its plans for meeting those total requirements over a reasonable period of time, that is, its capital budget.

The escalation of construction in the 1960s led to a pattern of large short-term borrowing by operating subsidiaries under bank lines of credit, paid by annual or semi-annual issues of bonds and preferred stock and of common stock investment by the holding company, which in turn was dependent on periodic offerings of its own common stock to the public. Day-to-day cash requirements of this financing cycle were managed by the flexible bank lines.

The Commission avoided a multiplicity of applications and orders by basing its authorization of the short-term or bank borrowing and the related investment by the holding company in its subsidiaries on a system budget, generally in the form of a single order authorizing maximum limits for a one or two year period. The budget that management prepares in the ordinary course of business for those large systems provides initial answers to the issues raised by Section 7(d), and the continued validity of the forecasts are again considered and reviewed when long-term security issues are authorized to retire the bank loans.

This principle was extended about two years ago to long-term financing, debt and equity. Volatile markets, due principally to rapidly fluctuating interest rates, were making it difficult to fix the amount and timing of a public offering too far in advance. But it was simple to modify an order under Section 7 to include the full year's financing requirements, t be sold in one or more installments as market conditions dictated, since our review of the substantive requirements under Section 7 had actually been conducted under the budget method previously described.

This administrative revision has reduced the number of applications, notices, and orders, which had begun to increase as the need to issue long-term securities became more frequent. It anticipated the Commission's reform of the registration process pursuant to Rule 415 under the Securities Act of 1933. A public notice under the Act imposes a 30 to 40 day period between application and order, which is rarely exceeded for financing applications. It runs concurrently with the registration process under the Securities Act of 1933, as in effect previously and currently under the simplified registration recently adopted by the Commission.

5. Limitations on Short-term Borrowing

The large construction budgets, characteristic of electric utility companies over the past two decades, required continuous raising of new capital, typically through a financing cycle noted previously. For major utility companies, such as the registered systems, short-term borrowings are substantial. The lines of credit for the twelve registered systems have reached an annual level of about $7 billion a year, $500 million for the larger individual utility companies.

These funds are spent, viewed incrementally, on physical additions to permanent facilities. These expenditures are unlike financing of inventory or the acquisition of finished products for resale. The financial soundness of the loans and of the borrower depends on prompt refinancing by common stock and long-term securities. A failure to refinance the current year's loans might imperil the ability to complete construction on time, and deferred construction may be costly to investors and consumers. Accordingly, the principal test for short-term debt authorization under the Act is the ability to repay in a timely fashion. The cases of Georgia Power Company and Alabama Power Company, both subsidiaries of The Southern Company, provide good examples of the intricate effects of unanticipated events.

In 1973 Georgia Power Company, then a $2.5 billion electric utility company serving most of the state of Georgia, was engaged in a construction program for which it had budgeted $3.3 billion in the next four years. Both it and Southern were experiencing some difficulties in raising long-term capital to finance this rate of growth. A consumer group intervened to oppose Georgia's $150 million bond issue, scheduled for sale early in 1974, and its application for $250 million short-term borrowing. The Commission summarily approved the bond issue, which was required to refund outstanding short-term debt.* The Commission also authorized the sale of $165 million of Southern common stock principally for investment in Georgia.** It set for hearing the short-term application for $250 million of bank loans. After an evidentiary hearing and review, the Commission granted the requested authorization.***

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* Georgia Power Co., 45 SEC 427 (1974)
** The Southern Co., 45 SEC 623 (1974)
*** Georgia Power Co., 45 SEC 610 (1974)

Three months thereafter (HCAR No. 18750), Georgia Power reduced the burden of its enormous construction program by changing its historical policy of 100% ownership of its generating plants. It sold undivided interests in the plants under construction to rural electric cooperatives and to municipalities, both wholesale customers of Georgia Power. It recovered about $200 million for prior construction costs to the date of sale, and the new joint owners would share in future construction costs. The initial $200 million was immediately applied to repayment of bank loans. Georgia has not made significant use of short-term loans since 1975.

Its associate company, Alabama Power Company, faced a somewhat different problem with its bank loans. Alabama Power was unable to undertake long-term financing because of inadequate earnings attributed to prolonged rate litigation, but in the meantime it had built up a formidable level of short-term debt. In March 1979, the Commission refused to authorize a request to increase Alabama's borrowing authorization from $305 million to $555 million (HCAR No. 20970) for lack of evidence of ability to repay. When rate increases were allowed in July 1979, the needed additional borrowings were authorized by the Commission the following month (HCAR No. 21188). About 12 months later, when Alabama's full year's earnings reached the level required under its bond indenture, funding to commerce retirement of its $400 million accumulated bank loans was authorized by the Commission (HCAR No. 21711). It was completed by the end of 1981.

6. Statements of Policy on Bonds and Preferred Stock and Callability

As noted previously, in 1956 the Commission adopted policy statements regarding certain basic terms for bonds and preferred stock. Actually, the statements codified what had been developed in the course of reorganizations under the Act. Extensive comments were reviewed prior to their formal adoption.

First mortgage bonds must be callable on payment of a reasonable redemption premium. This permits the issuing company, if interest rates decline, to redeem any outstanding series by sale of new bonds at a lower interest cost. Except for refunding maturing bonds, additional bonds may be issued only to the extent that (a) the total amount of bonds to be outstanding are not more than 60% of the defined value of bondable property (property coverage); and (b) operating income, before income taxes, of the issuer for at least 12 consecutive months in the previous 15 months, is at least twice the annual interest requirements on the bonds to be outstanding and prior obligations (interest coverage).

A renewal and replacement fund, representing essentially the straight line depreciation allowance, currently about 3% of depreciable property, and a sinking fund of at least 1% of the total original principal amount of bonds issued under the indenture (deducting series fully retired) must be set aside annually. These requirements may be and usually are satisfied by certifying property additions. The alternative is retirement of bonds. Each series of bonds restricts the payment of common dividends to earnings subsequent to its issuance plus an amount not to exceed one year's current dividend requirements. Past accumulations of retained earnings, which are universally invested in physical plant, are in effect treated as permanent common equity.

Preferred stock, like bonds, must be callable. Preferred dividends must be cumulative and preferred shareholders shall have the right to elect at least a majority of the board of directors as long as four quarterly dividends are in arrears. The issuing company may not acquire shares of its preferred stock if preferred dividends are in arrears. Unsecured debt may not exceed 20% of capitalization, with a sublimit of 10% on such debt of less than 10 years maturity, without the consent of at least a majority of the preferred stock. As restrictions are included in the articles of incorporation, the consent of the preferred stock requires a vote to amend the articles.

Coverage tests for issuance of additional preferred stock require that (a) income before interest for 12 consecutive months in the previous 15 months be at least 1.5 times the sum of the issuer's interest and preferred dividends, and (b) common equity at least equal to the involuntary liquidation preference of the preferred stock (a 200% book equity).

The Commission's statement of policy regarding first mortgage bonds specified that the indenture "shall provide that the bonds can be called by the obligor for redemption at any time upon reasonable notice and with reasonable redemption premiums, if any." In the absence of very special circumstances, the maximum initial redemption premium is one year's interest, declining at defined intervals over the life of the issue.

The Commission amended this requirement in 1969 (HCAR No. 16369), to permit an initial five-year bar on refunding "by the issue of debt securities at lower interest costs." The refundability restriction, unlike a "no call" provision, preserved the issuer's right to retire the issue at any time, but protected holders from the risk of the bonds being redeemed quickly to take advantage of an early change interest rates. The five-year period was based on extensive data indicating strongly that the five-year non-refundability clause produced a modest, but significant, reduction in interest rates, on the order of 1/4 of one percent. It allowed also a like limitation on preferred stock (HCAR No. 16758).

On October 23, 1975 (HCAR No. 19224), the Commission invited public comment on whether the period should be extended to ten years. The Commission noted that the ten-year clause was widely used during the difficult markets from June 1974 to January 1975. Its request for comments sought information as to the views of institutional investors who have been substantial purchasers of utility bonds and preferred stock, and for quantitative data as to any interest differential. After reviewing the comments, the Commission announced (HCAR No. 20509) that no change would be made. The record, including a staff analysis of all significant public sales of utility senior securities for 1975 and 1976, did not support the suggestion that a measurable reduction in cost of money would result from extending non-refundability to ten years.

One of the reasons for providing callability is the Commission's experience with non-callable senior securities. They impeded adjustment of the company's operation to changing conditions. The reorganization powers of Section 11(b)(2) had to be invoked to cut more than one of these Gordian knots. Liens and covenants incident to an outstanding bond series restrict the issuing companies for 25 or 30 years and may take on a significance entirely unanticipated. Sometimes redemption may not be economical, and bondholder consent to modification of the indenture may not be forthcoming except at a price the company cannot afford to pay.

A special kind of adverse effect was examined recently by the Commission in West Texas Utilities Company (HCAR No. 21041). The bond indenture of this subsidiary of Central & South West Corporation required that the utility company's income, for purposes of dividend payments and issuance of new bonds, be calculated by deducting the difference between 15% of its operating revenues and its actual maintenance expense, rather than deducting the depreciation allowance.

The percent-of-revenue clause was widely used when the indenture was created in 1943, because manipulation of plant accounts and depreciation accounting in the 1920s left little credibility for the book figures. An important aspect of reorganizations under the Act and concurrent action by other regulatory agencies was a general audit and revision of capital accounts and depreciation. The Commission's 1956 Statement of Policy adopted a depreciation allowance as a standard for future indentures, but the outstanding percent-of-revenue clauses remain in effect as long as bonds issued thereunder continued to be outstanding. In West Texas case this would be until the year 2003.

The calculation continued to produce a reasonable approximation of the depreciation allowance until fuel cost escalation in the early 1970s disrupted that historical relationship. The revenues to pay for the increasing cost of fuel had no relationship to plant or maintenance, and 15% of the additional revenues produced large excess deductions. In only five years the restrictions forced a serious distortion in West Texas capital structure, increasing its common equity ratio by 8%, to 55.5%, and reducing the debt ratio to 40.9%.

In utility finance and ratemaking, such ratios mean generally that capital is being raised inefficiently and at excessive cost, to the prejudice of both investors and consumers and contrary to the requirement of Section 7(d)(3) of the Act. In the West Texas case the indenture happened to contain a clause authorizing the Commission by order to permit dividends despite the restriction. Accordingly the Commission's order authorized West Texas to borrow $15 million to pay a special common dividend which restored its capitalization to a 52.8% debt and 43.7% common equity. For the future the order authorized payment of common dividends based on earnings for the previous 12 months computed under depreciation accounting.

7. Lease Financing

In the early 1970s, the development of sale and leaseback financing presented a serious problem under the Act. Under this type of financing, a trustee--usually a bank or other financial institution--and the beneficial owners, who supply the equity financing, own the equipment that is leased to any utility company, whether or not this utility company is subject to the Act. Sections 2(a)(3) and 2(a)(4) in effect define respectively an electric and gas utility company as a company that "owns" or operates any utility facilities or any associated physical part thereof. Read literally, that would make the lessor and each benefical owner a public-utility company, and any parent thereof a holding company.

After granting at first individual applications for exemption, the Commission proposed Rule 7(d) (HCAR No. 17843) and adopted the same on May 31, 1973 (HCAR No. 17980), based on its authority under Section 20(a) to define technical terms. It determined that the lessor as trustee and the beneficial owners would not be deemed to "own" leased facilities provided that the terms of the lease with the public utility were approved by the State commissions having jurisdiction over its rates and services. It required the filing of a simple certificate of compliance to establish exclusion from the Act. Lease financing by this simple procedure proved effective, as shown by the following table:

RULE 7(d) CERTIFICATES
-in millions-

Year	Utility Equipment	Nuclear Fuel	Other	Total
1973	$ 107	$ 338	$ 21	$ 466
1974	87	82	4	173
1975	19	114	—	133
1976	360	579	—	939
1977	2	99	—	101
1978	269	243	1	513
1979	7	998	—	1,005
1980	12	575	—	587
1981	40	2,043	22	2,105
1982 (5 months)	650	2,165	—	2,815
	$1,553	$7,236	$48	$8,837

The liberalized leasing requirements of the Economic Recovery Tax Act of 1981 revived in another form some of the interpretive questions referred to. They were resolved by a public release of the Commission on November 4, 1981 (HCAR No. 22259), as soon as the Internal Revenue Service issued pertinent regulations under the new law, which in effect allow the sale of tax credits but in the form of a sale and leaseback. The Commission's release concluded that qualified leases under the amended tax laws did not involve either a disposition or acquisition of utility facilities or securities requiring authorization by the Commission under the Act for members of registered systems, and that the tax title to such facilities attributed to lessors was so attenuated that lessors were not deemed owners under Sections 2(a)(3) and 2(a)(4) of the Act, and hence did not need the exclusion pursuant to the terms and conditions prescribed by Rule 7(d).

II

1. Acquisitions (Sections 9 and 10)

Section 9(a)(1) requires Commission approval for an acquisition of securities, utility plant, or any interest in any other business, by any member of a registered holding company system, and Section 10 specifies the standards to be applied in granting such authorization. Section 9(a)(2) requires approval under the same standards for acquisitions by any others who, as a result of acquisitions, become affiliates of two or more public-utility companies. For this purpose, an affiliate of a public-utility company means any person or company that, directly or indirectly, owns or controls 5% of the voting securities of such company. The two or more acquisitions subject to Section 9(a)(2) may occur in sequence or concurrently. An acquisition by a company of all the stock of one public utility makes the acquiring company a holding company. If only one utility is involved, this single acquisition is not subject to Section 9(a)(2) and hence requires no approval under Section 10. But the new holding company must register unless it qualifies for exemption.

Section 10 is linked to Section 11. Section 10(c) provides that an acquisition shall not be approved unless the Commission finds that it will tend toward the economic and efficient development of an integrated public-utility system (defined in Section 2(a)(29)), or if it is "detrimental to the carrying out of the provisions of Section 11." In substance, Section 9(a)(1) bars a registered holding-company system from making an acquisition if Section 11 would prohibit its retention. Section 9(a)(2) is directed to controlling the creation of new holding companies by making two or more utility acquisitions subject to the standards of Section 10, even if the holding company qualifies for an exemption under Section 3(a) of the Act.

Section 10(b) relates approval of the acquisition to a determination of whether the price is reasonable, whether it would result in an undue concentration of control, and whether it will unduly complicate the capital structure of the holding-company system or affect its proper functioning. Section 10 does not preempt state laws. Acquisitions, like financings under Sections 6 and 7, must comply with applicable state laws.

2. Acquisitions of public-utility companies.

Such acquisitions do not occur often. Utility systems have expanded to meet increasing demand largely through internal growth, joint utility ventures and regional power pools. But acquisitions of independent utilities by holding companies have come to the Commission from time to time.

In 1975 the Commission declined to approve a new holding-company system that would combine New England Electric System and Eastern Utilities Associates, both registered holding companies, and Boston Edison Company, because of insufficient evidence to support the claimed operating savings as a result of the affiliation.* It approved the organization of a new holding-company system, Northeast Utilities, with three utility subsidiaries, one in Massachusetts and two in Connecticut.** It approved the acquisition, by a tender offer, of the stock of Columbus and Southern Ohio Electric Company by American Electric Power Company (HCAR Nos. 20633, 21433, 21768). Other acquisitions, not of such magnitudes, have been approved by the Commission.

3. Joint Ventures (Rules 14, 15, 16)

Rule 14 is directed to a joint venture in a "power supply company," which is an electric utility company as defined in Section 2(a)(3) of the Act, because it is organized as a separate entity, unlike generating facilities jointly owned by participating utilities as tenants in common. Thus, without Rules 14 and 15, participants otherwise not subject to the Act, would be required to apply with the provisions of the Act relating to acquisitions and exemptions.

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* New England Electric System, 45 SEC 684 (1975).
** Northeast Utilities, 42 SEC 963 (1966).

To encourage such joint projects Rule 14 exempts participating utilities from Sections 9(a)(2) and 10 as to this project company. One of the conditions of the exemption is that financings and acquisitions are expressly authorized by the appropriate commissions with authority over rates and service. Rule 15 provides that the exemption for a holding company is not affected by an exempted acquisition under Rule 14 (HCAR No. 21881). The participation in a power supply company by a registered system remains subject to Sections 9(a)(1) and 10. These requirements did not pose the problem to which Rules 14 and 15 are addressed.

Rule 16, adopted in November 1980 (HCAR No. 21797), provides an exemption from affiliate or subsidiary status for a joint venture to construct pipeline facilities or a coal gasification plant. Such ventures are not utility businesses under the Act. But if a registered holding company, directly or through a subsidiary, were to acquire a 10% participation interest, the project company would be a subsidiary of a registered holding company. A registered holding company may experience some difficulties in attracting other participants, and inversely other participants not subject to the Act might for the same reasons exclude the registered holding company. The exemption provided by Rule 16 extends to such projects only if the participation interest of the registered holding company does not exceed 50%. The exemptive provisions of Rule 16 extend also to affiliates of the project company.

4. Organization of Fuel Subsidiaries

The organization by a registered holding of a subsidiary to buy or develop fuel supplies for its associate companies is a non-utility business, though functionally related. Its organization and acquisition is subject to Section 9(a)(1), which includes an acquisition of any interest in another business, and the required approval is governed by the relevant provisions of Section 10. Sales to associate utilities are subject to Section 13(b), which provides that such services be "performed economically and efficiently for the benefit of such associate companies at cost, fairly and equitably allocated among such companies." Exemptions from cost are authorized, by rule or order, conditionally or unconditionally, in cases that "involve special or unusual circumstances" or on other grounds therein stated.

Ownership of mines and related transportation facilities were not uncommon in 1935, and their retention was permitted by the Act. However, the fuel supply for the exponential growth of generation capacity in the 1950s and 1960s was procured in the market or by contract with independent producers. The majority of electric holding company systems were dependent on oil and gas as a fuel for electric generation, partly due to conversion from coal in the late 1960s. These included Central and South West Corp. ("C&SW"), Middle South Utilities Corp. ("Middle South"), New England Electric System ("NEES"), General Public Utilities Corp., and Northeast Utilities.

American Electric Power Company ("AEP") expanded its own coal supplies, but less than 15% of its annual consumption came from AEP coal subsidiaries.

The fuel crisis that emerged in the 1970s drastically affected the fuel supply of electric utility companies. Market prices and the utilities' costs escalated, established supplier relationships were impaired, and concurrent economic problems in the transportation industry created significant uncertainties about reliability of delivery. Large advances, guarantees, and other concessions were demanded by unaffiliated suppliers, in addition to liberal escalation clauses as to price.

Many of the larger electric utilities, including the registered systems, responded by acquiring their own supply sources for a substantial percentage of their fuel requirements and transport. In 1971, Middle South established System Fuels, Inc. ("SFI"). In 1974, NEES added New England Energy, Inc. ("NEEI"), and in 1978, C&SW established Central and South West Fuels, Inc. ("C&SW Fuels"). With natural gas and oil becoming more volatile as to price and availability, the electric registered systems also undertook to construct coal-fired baseload plants to meet future needs for electric power.

AEP greatly expanded its own fuel sources through coal mining subsidiaries in West Virginia, Ohio and Utah. C&SW, through its fuel procurement subsidiary, purchased coal reserves in Texas, Oklahoma, and Arkansas. During the 1970's, Middle South and NEES remained dependent on oil and gas as boiler fuel. At present, Middle South is constructing coal-fired and nuclear power generating plants, but for the remainder of this decade will be dependent on oil and gas for over 40% of generation needs. The NEES system, which was dependent on fuel oil and natural gas, is now converting baseload oil plants to coal.

Mining, oil and gas development and transportation all involve large capital investments, so the cost of capital is an important factor. As the fuel subsidiaries are wholly-owned, cost of capital computations are based on the imputed capital structure of the utility companies that are served, applying the actual cost of money for that utility company's senior security issues and the return on common equity allowed in the most recent rate case, with appropriate adjusting provisions. The total price is based on full pooling of costs, including amortization of the exploration and development costs.

Fuel development by associate companies often requires ancillary facilities, such as coal cars for unit train service and oil barges. Their continuous use for service to the utilities may not be economical or efficient. Accordingly the fuel companies have been authorized to use idle equipment or surplus capacity to serve non-affiliates on condition that resulting revenues or income be credited against the cost of service supplied to the associate utility companies.

SFI, established in 1971 as a fuel procurement arm of the Middle South system, is a direct subsidiary of Middle South's four electric operating utilities. Until 1976, SFI was principally involved in fuel inventory procurement and in oil and gas exploration. In 1976, SFI service was expanded to include all nuclear fuel acquisition, conversion, fabrication, and delivery to the operating companies. Middle South had built one nuclear plant and had under construction three additional facilities to be placed in service in the 1980s. To meet these growing needs for nuclear fuel, particularly the yellow-cake mineral, SFI began in 1978 a uranium exploration program. In the four-year period ending December 1981, SFI had spent $24.8 million on uranium exploration with little success. In March 1982, we were informed by SFI that the uranium exploration program would be abandoned this year.

SFI purchased during the early 1970s tow boats and barges for fuel oil transportation. In 1980, as a result of substanial increase in domestic supply, natural gas was used instead of fuel oil for electric generation. From 1980 to the present time SFI has subleased its excess vessel capacity to non-affiliates. In 1981 gross revenues generated from these subcharters amounted to $7.3 million, all of which was applied to reduce the cost of fuel oil transportation billed to the operating utility companies.

C&SW Fuels is a direct subsidiary of the four electric operating companies of C&SW. It was established in 1978 to function as the procurement and exploration arm of the holding-company system. During the last four years it has been engaged in extensive gas and oil exploration in the Gulf Coast region and in the acquisition of thousands of acres of mineral lease rights for lignite in Texas and Arkansas. The fuel company is responsible for developing, alone or by joint ventures with a non-affiliate, lignite mines dedicated to mine-mouth generating plants of the operating companies. The four electric operating utilities of C&SW have all acquired, individually or jointly, rail cars to haul coal from Wyoming to their respective service territories. Should excess coal car capacity develop, these utilities have been authorized to sublease to non-affiliates on conditions previously indicated. The fuel company is now acquiring coal reserves in northern Texas, which will reduce transporation costs.

The coal mining subsidiaries of the public-utility companies in the AEP system are principally engaged in the supply of coal to generating plants of the operating utility company that owns them. The AEP system has developed one of the few utility-owned and operated coal barge and transloading transportation systems for the movement of coal from mine to generating plant. The operating utilities own over 6,000 coal railroad cars to haul coal both from Wyoming and Utah to the Mississippi River and within the Appalachian region of Ohio, Virginia, and West Virginia. During the last 12 years, AEP has expended over $1.1 billion on coal mine development, expansion and related transportation facilities. The AEP system now provides for its utility subsidiaries over 40% of their coal requirements, which exceed 43 million tons annually.

NEEI, wholly-owned by NEES, was organized to provide fuel for New England Power Company ("NEPCO"), the generating and transmission subsidiary for the NEES system. It has been engaged in a joint venture, since 1974, with Samedan Oil Corporation, a non-affiliate, for oil and gas exploration (HCAR No. 18635), under which NEEI receives 50% of all reserves acquired.

During the 7-1/2 years to date, NEEI has invested $262 million in the joint venture. As of March 31, 1982, the joint venture had drilled 994 wells, of which 60% were productive. This program has provided for NEEI 13.1 million equivalent barrels of proven and probable oil and gas reserves, of which 79% is natural gas. Since NEPCO does not use natural gas in its generators, NEEI sells or exchanges the same to or with non-affiliates to obtain suitable fuel oil for NEPCO. As a result NEEI has saved NEPCO more than $6.7 million in fuel expenditures. In December 1980 NEEI undertook a similar joint-venture with another oil company, investing $53.3 million. At the end of its first year that joint venture was terminated as unproductive.

NEPCO is now converting much of its power generation to coal. NEPCO proposes to enter into long-term contracts for coal supply with independent producers in Virginia, West Virginia, and Pennsylvania, and for rail transportation to coastal ports. The price of purchased coal and its rail transportation is estimated at about 87% of total cost, exclusive of maritime transportation to Massachusetts. For that service, NEEI has entered into a joint venture with an independent shipping firm for construction and operation of a self-unloading collier, which will be chartered by the joint venture to NEPCO for 24-1/2 years.

The time charter specifies an annual transportation charge that is subject to adjustment annually, and subject tc further review at five-year intervals. It includes also provisions for arbitration in case of dispute. The shipping firm, the partner in the joint venture, had no interest in a management contract, nor in a profit that represented a utility rate of return. NEES requested, and the Commission granted an exception from cost under Section 13(b) (HCAR No. 22309). The Commission noted that the terms of the charter, not a arm's-length transaction, was not the final answer as to price. NEPCO's rates were subject to the jurisdiction of the Federal Energy Regulatory Commission under the Federal Power Act. That agency will ultimately determine how much in revenues it will allow, as a cost of transportation, in rates charged to NEPCO's wholesale customers, principally the NEES distribution companies. It may allow the amount computed under the charter between the parties, or some other amount, whatever is just and reasonable.

In the 11-year period 1971-1981 expenditures for fuel and related facilities by registered holding companies amounted to about $4.2 billion. Appendix A attached hereto provides the details.

III

Exempt Holding Companies (Section 3(a) and Rule 2)

Section 3(a) of the Act provides exemptions for five classes of holding companies, two of which are pertinent here. Section 3(a)(1) provides an exemption for a holding company if it and its public utility subsidiaries are organized in the same state and carry on the utility business substantially in that state. Section 3(a)(2) exempts a holding company that is itself predominantly a public utility which operates in the state of its organization and contiguous states, and which, as a holding company, has one or more relatively small utility subsidiaries.

The introductory clause of Section 3(a) provides that the Commission shall exempt a holding company that meets the statutory criteria "from any provisions or provisions" of the Act "unless and except insofar as it finds the exemption detrimental to the public interest or the interest of investors or consumers . . ." This permits the Commission to exempt the holding company from some but not all provisions of the Act, depending upon its findings under the "unless and except" clause. An exemption may be qualified or subject to conditions or, in a particular case, denied altogether. In addition, Section 3(c) provides that the Commission shall revoke an order of exemption if it finds "the circumstances which gave rise to the issuance of such order no longer exist."

Section 3(a) authorizes the Commission to grant exemptions by order. Under the Act an order is preceded by an application, which is followed by a notice of filing that gives interested persons a right to appear, to object and to request a hearing. In any proceeding, a state commission has an absolute right to intervene and be heard. On expiration of the notice period, or after a hearing, an order is issued. Section 3(c) provides that if an application is filed in good faith, meaning that a prima facie claim for the exemption is stated, the holding company is exempt pending final action by Commission order.

Section 3(a) also provides that an exemption may be granted by rule. Rule 2 under the Act (17 CFR §250.2) provides that a holding company claiming an exemption under Sections 3(a)(1) or 3(a)(2) need not file a formal application for an order. Instead the company may file a statement claiming the exemption, which, if in good faith, exempts the holding company. No notice is published and no order is issued. The statement must be renewed each year, accompanied by financial statements for the holding company and the utility subsidiaries. Rule 6 (17 CFR §250.6) provides that an exemption under Rule 2 may be terminated by a letter from the Commission stating that questions exist concerning the holding company's exempt status. In that event, the holding company has 30 days to respond. It may either register as a holding company or file a formal application for exemption, which, if in good faith, exempts the holding company until the Commission issues an order concerning the exemption. Rule 6 is based upon Section 3(c), which authorizes the Commission to revoke an exemption previously granted if conditions have subsequently changed.

Rule 2 is an effective administrative technique. It permits the holding company to secure the exemption promptly, if the filed statement is in good faith, without a formal application, notice and order. The annual renewal of the exemption permits periodic review of the holding company's exempt status in terms of the public interest and interest of investors or consumers on the basis of actual developments rather than by imposition of conditions at the outset when the holding company is first organized.

Challenges to a holding company's exempt status have been rare. Proceedings were initiated to test the extent to which Section 11(b) applied to exempt holding companies. The two cases were Pacific Lighting Corp. and National Utilities & Industries Corp.* It was no accident that the two cases involved gas companies. This was in an era of perceived declining gas reserves and limited construction needs, so some gas companies began diversifying into other businesses. After the Penn Central collapse, it seemed an appropriate time to consider the extent to which operations of a regulated gas distribution company may be combined with unregulated businesses under a holding company in light of Section 11(b)(1).

In a 1936 order the Commission had granted Pacific Lighting an exemption as an intrastate holding company. Its four utility subsidiaries (thereafter consolidated) were engaged in the retail distribution of natural gas in southern and central California. It subsequently organized other subsidiaries to engage in utility related ventures. In 1969 it initiated a program of acquisitions of companies wholly unrelated to its gas utility business. These included real estate subsidiaries in California and Hawaii and others engaged in farming and marketing citrus fruit and pistachio nuts. The diversification program was completed in 1971. Its non-utility related assets comprised about 14% of its total assets. In 1969 National Utilities was organized as a holding company over Elizabethtown Gas Company, a small gas utility in New Jersey. Its non-utility subsidiaries included investments in a commuter airline, a travel agency and a data processing firm. Its non-utility assets were about 9% of total assets.

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* 45 SEC 152 (1973) and 45 SEC 167 (1973).

National had claimed an exemption under Rule 2, but when notified of its termination, National applied for an order under Section 3(a)(1). Hearings were ordered, which commenced June 15, 1971 and concluded July 13, 1971. With respect to Pacific Lighting, the Commission, on August 13, 1971, ordered a hearing to determine whether its exemption shold be revoked or modified. Hearings commenced November 22, 1971, and concluded January 24, 1972.

Two commissioners substantially agreed with staff's position, holding that non-utility activities should be complementary to the utility business. The two other commissioners held that Section 11(b)(1) applied strictly only to a registered holding company. They agreed, however, that "adverse consequences" could result from diversification, and stated that under the "unless and except" clause the Commission was required to prevent "undue risks to investors and consumers" from expansion into non-utility businesses. They suggested guidelines. Departure from them "would, at least presumptively, warrant an adverse finding under the 'unless and except' clause." Among the suggested limits were (1) that the non-utility ventures be in separate corporations and (2) that they be relatively modest in terms of the entire system, so that the utility business would remain the predominant business of the holding company system, thereby minimizing the extent of the risks to the utility from financial reverses of the non-utility ventures. The effect of the 2-2 vote was to permit Pacific Lighting's order of exemption to continue. National has remained an exempt holding company on the basis of its application under Section 3(a)(1), and later disposed of its investments in the travel agency and the commuter airline.

Since these two 1973 decisions, the Commission has not further defined the extent of diversification permitted exempt holding companies under the "unless and except" clause. Holding companies organized since then with an interest in diversification have claimed exemptions pursuant to Rule 2. The claim to exemption is considered made in good faith, since it is not assumed that the guidelines will be exceeded, that the holding company will be imprudent in its financing, or that non-utility ventures are destined to fail.

A special situation was presented when Lykes Bros., Inc., acquired the stock of Peoples Gas System, Inc. in 1976. Lykes was a Florida corporation engaged in food processing, cattle ranching and banking. Its non-utility investments far exceeded the investment in Peoples, a natural gas distributor in Florida. A neighboring utility, Florida Gas Company, had been interested in acquiring Peoples for stock, but Lykes offered cash which the controlling stockholders of Peoples preferred. Lykes claimed exemption under Rule 2, which was terminated under Rule 6. Lykes thereupon filed a formal application for an order under Section 3(a)(1). Briefs were filed, with staff urging that Lykes be granted an exemption on condition that it dispose of Peoples. Lykes agreed to a divestiture under a plan, which the Commission approved, providing for the distribution of Peoples stock to stockholders of Lykes (HCAR Nos. 20487 and 20570). Subsequently a conglomerate acquired control of Florida Gas Transmission, a pipeline subsidiary of Florida Gas, and Peoples acquired the retail properties of Florida Gas.

The only other case of termination of a Rule 2 exemption involved Colonial Gas Energy System, a small holding company with two retail gas subsidiaries in Massachusetts. It had claimed exemption under Rule 2 for many years prior to September 9, 1977, on which date its claimed exemption was terminated because of the deteriorated financial condition of Colonial and its subsidiaries. In 1977 the consolidated system's capitalization included 23% short-term debt and only 18% common equity, and the utility subsidiaries were not able to sell bonds for want of sufficient common equity which Colonial was unable to provide. Thereafter the staff worked with Colonial to develop financing plans. Colonial agreed that the holding company was really not necessary, and the Commission approved Colonial's plan to merge the holding company with its operating subsidiaries (HCAR No. 22144).

Today there are 91 holding companies exempt under Sections 3(a)(1) and 3(a)(2). Twenty-five are exempt by order, and 66 are exempt pursuant to Rule 2. At December 31, 1977, there were 51 holding companies claiming exemption under Rule 2, of which 42 are still extant. Since January 1, 1978, 24 operating utilities created holding companies with claimed exemptions under Rule 2.

FUEL PROGRAM EXPENDITURES OF REGISTERED HOLDING COMPANY SYSTEMS
(FISCAL 1971—FISCAL 1982)
(IN MILLIONS OF DOLLARS)

Fiscal year expenditures:

1981 = $1.030 billion
1980 = $597.9 million
1979 = $460.6 million
1978 = $184.0 million
1977 = $342.0 million
1971-1976 = $1.586 billion (average per year = $264.3 million)

Total eleven year period = $4.2 billion (average per year = 381.8 million)

Approximate
Holding Company Systems Expenditures
1971-1981 Breakdown:

Name of Holding Company	Oil Gas Exploration and Financing	Coal Exploration Development	Coal Mining Expansion	Uranium Exploration	Financed Fuel Oil Inventory	Financed Nuclear Fuel Procurement	Fuel Transportation and Storage	Coal Gasification
American Electric Power Co.	$ —	$515.0 (E)	$555.9 (E)	$ —	$ —	$ 91.0	$ 60.3	$ —
Central and South West Co.	383.4	84.7	—	6.6	—	—	66.1	—
General Public Utilities	—	35.0	—	—	—	—	—	—
Middle South Utilities	436.7	18.0	21.5	24.8	215.2	391.4	139.2	—
New England Electric System	223.2	—	—	—	—	6.0	—	—
Northeast Utilities	—	—	—	—	—	51.0	—	—
Southern Company	—	—	—	—	—	60.0	36.4	—
Columbia Gas System, Inc.	421.2 (E)	—	—	—	—	—	—	25.0
Consolidated Natural Gas	257.0 (E)	—	—	—	—	—	—	13.0
National Fuel Gas System	18.1	—	—	—	—	—	44.3	—
Total 1971-1981 by program =	$1,739.6	$652.7	$577.4	$31.4	$215.2	$599.4	$346.3	$38.0

Total 1971-1981 = $4.2 billion

(E) Estimated

Senator D'AMATO. Thank you very much, Chairman Shad.

Mr. SHAD. Now Commissioner Longstreth will give a brief comment on the three amendments.

Mr. LONGSTRETH. I am pleased, Chairman D'Amato, to have the opportunity to testify before you this morning. I want to elaborate somewhat on why we decided not to support any of the three proposed amendments.

These proposals would leave the act's regulatory structure nominally in place, while eroding its effective reach, either through questionable distinctions between industry segments, or through selective curtailment of the Commission's existing powers.

In short, they would leave the Commission with the appearance of responsibility but without the authority to discharge it.

Two of the three amendment bills pending in the Senate—S. 1870 and S. 1871—would alter the 1935 act to benefit, in one case, gas utility companies and in the other, the approximately 90 utility companies that are conditionally exempt from the act.

S. 1871 would redefine the term "public utility holding company," to exclude all three gas utility companies presently registered under the act, as well as most exempt gas companies. While this bill has the merit of simplicity, it is not justified by any relevant distinction between gas companies and electric companies.

The arguments advanced in support of excluding the gas utility industry from application of the act—and they are effective arguments—are equally valid when used in support of total repeal.

The exempt holding companies and operating utilities who have sponsored S. 1870 contend that the 1935 act indirectly limits their freedom to use a holding company structure to diversify their business activities. Accordingly, this group proposes to expand the categories of holding companies entitled to exemption and to remove the Commission's authority to deny or revoke their exemptions for any reason.

The expanded exemption would greatly reduce the continued validity of the act by removing the great majority of utility holding companies from the Commission's jurisdiction, and encouraging others to reorganize so as to qualify for what would be an unconditional exemption.

The third industry-sponsored bill, S. 1869, which is supported by most registered electric utility companies, goes beyond the other two bills in its limitation of Commission regulation under the act. It comes close to a de facto repeal of the statute.

S. 1869 would eliminate the requirement of advance Commission review of acquisitions of nonutility concerns by a registered holding company and the requirement of advanced Commission approval of most types of financing. It would also remove the Commission's jurisdiction over certain affiliate transactions. S. 1869 would leave the Commission with little more than limited and unwieldy post hoc powers to order divestiture.

Although these industry proposals are motivated by the desire to facilitate greater diversification into nonutility businesses, the Commission has concluded that there are other reasons why the 1935 act unduly burdens the utility industry in a manner no longer justified by the interests of investors, consumers, or the public.

These reasons have been outlined by Chairman Shad and are explained in detail in the Commission's statement.

Accordingly, the Commission believes that the repeal of the 1935 act is appropriate at this time, and that repeal, in contrast to amendment, would represent the most effective and responsible legislative response to the issues being addressed here today.

Senator D'AMATO. Thank you very much.

Chairman Shad, obviously, one of the difficult aspects of the job of Congress is to draft legislation that will continue to be relevant even if the circumstances of an industry change over time. While repeal of the Holding Company Act may seem like appropriate action to take at this point in time, given the current financial problems which the industry has, could this action take on different significance if economic conditions were to improve in the industry?

ACT HAS SERVED ITS PURPOSE

Mr. SHAD. I'd still think that the act should be repealed because it has served its purpose. Merely to continue to subject a minority portion of this industry to limitations, inhibitions, and restrictions that do not apply to 80 percent of the industry nor to any other utility holding company categories seems unreasonable to me.

You've got telephone holding companies, sewage, communication, transportation, and a whole host of other holding companies which are being effectively regulated by both State and Federal agencies but are not subject to the SEC's involvement in their internal decisionmaking processes.

It's not a question of our merely requiring disclosure and reporting. We'll continue to have all the full disclosure requirements and registration requirements of these companies that we've had in the past. We'll continue to have the Federal Energy Regulatory Commission prescribing wholesale rates and accounting standards and other requirements, and you'll still have the states regulating rates, which are the consumer's concern.

I think what we're talking about is simply pulling out a blanket of regulation that's imposed on a small segment of this industry—really for past sins, sins of the twenties. We're still requiring these companies to comply with restrictions and limitations and inhibitions that are not imposed on comparable businesses in America.

Senator D'AMATO. So, the question comes down to whether the so-called past sins could recur and whether consumers may still need the protections which the act initially rendered to them. Some witnesses at these hearings have testified—and I am certain others will testify in future hearings—that most of the act's provisions are still necessary for the protection of investors and ratepayers.

The SEC has in the past shown a willingness to have the consumer protection provisions of the act transferred to another agency.

If the committee decides that other securities laws are adequate to protect investors, as you have testified, but that some consumer protections are still needed, should the SEC continue to implement those provisions of the act which may be retained?

Mr. SHAD. Well, the consumer category here, there is the investing public and the customers of the utilities. I want to emphasize again that the SEC has nothing to do with the regulation of rates that the customers of utilities pay.

Senator D'AMATO. That is true. But ultimately, the investments and the management decisions which are made by the company have a very direct bearing on what those rates are. So, there's a very real consumer interest implicated here—maybe not in terms of setting rates, but certainly in that the decisions made by the companies have a very direct effect on what the rates will be.

AREAS OF SEC RESPONSIBILITY

Mr. SHAD. Well, there are three areas for which the Commission has responsibility. One is intrasystem transactions within these 12 active holding company systems. The States also have complete regulatory authority here, and they're already handling it as to 80 percent of the industry. So, we're only talking about a fraction that is now subject to SEC jurisdiction over intrasystem transactions.

Senator D'AMATO. That speaks to another question that has been raised, the question of whether the State agencies have sufficient resources, in the way of personnel and expertise, to undertake this responsibility. Are you saying that the States already are regulating 80 percent of the industry, and that responsibility for the additional 20 percent would not present a problem or a burden for them?

Mr. SHAD. I think that if they don't have the capacity to properly monitor 80 percent of the industry, they ought to get it. This is not a major additional burden.

Senator D'AMATO. So, you don't see this as a major burden?

Mr. SHAD. The act only relates to three areas. The other two are financings and acquisitions. Financing by the holding company would probably not come within the State's jurisdiction. They would as far as the operating companies are concerned.

Any nonsense of upstreaming or milking the capital out of the operating company is completely within the control of the State regulators, and they ought to be on top of that—in fact, they are now. I don't think that's a seriously arguable issue—that the States are not effectively monitoring and regulating and prohibiting the milking of operating subsidiaries by their parents. I mean, that's just unacceptable, and the States are on top of it. The States are now regulating these 12 companies, so this is not a new burden area. They are monitoring any upstream financings or diversion of funds right now, including these companies. So, that's not a new area.

The other area is acquisitions. Because of the paper empires that were built in the 1920's and collapsed in the 1930's, the SEC was charged with the primary responsibility of simplifying and eliminating these holding company structures, which has been accomplished. That has been expressed as the heart of the act. The most important element was to break up these multitiered holding companies. So, that's been accomplished.

Yet the acquisition limitations are still imposed on these 12 companies, 12 out of—there have been 223 holding companies subject to the act since 1938. So, we're down to 5 percent of the group that has been subject to this act over the years. These 12 companies have all kinds of inhibitions on their ability to acquire other companies. That's not to say that every acquisition is going to be a gold mine by any means. But no other holding company systems are subject to comparable burdens in the United States. Does that seem reasonable? It doesn't seem reasonable to me.

Mr. LONGSTRETH. If you were to conclude, as we have suggested, that the disclosure system of the 1933 and 1934 acts would adequately protect the investor, so that you could eliminate that portion of the 1935 act that is designed to protect the investor, would the SEC have anything left to do in respect to protecting the consumer? The answer to that I think is no, because the consumer is protected by the SEC, not through ratemaking, because we have no power in that area, but through substituting our business judgment as to what is a sensible management and financial structure, capital structure, or diversification program, if any—for the judgment of the managers of the utility holding companies. Through that process, we indirectly, really, are supposed to be protecting the consumer.

Senator D'AMATO. Let me interrupt if I may.

What you're saying is, in essence, you want to get out of the business of second-guessing business judgments; isn't that what you're really saying?

Mr. LONGSTRETH. Well, we think that being in that business, we're no longer useful.

Mr. SHAD. We're not only second-guessing it, we're precluding it. They have to come in before they do it. It's one thing to say, "Well, you didn't make a good deal." But before they can make the deal, they have to go through the SEC.

Senator D'AMATO. Let me ask you one other thing. Should there be any restrictions on the change or concentration of control over utility systems?

Mr. SHAD. Change in concentration and control?

Senator D'AMATO. Change or concentration of control.

Mr. SHAD. The individual States have the authority to require approval of the transfer—not only control—but of fractional interests—as small as 5 to 10 percent interests.

Senator D'AMATO. Chairman Shad, I want to thank you and Commissioner Longstreth for coming in today and sharing with us your views and, I think, making some very cogent arguments.

It's unusual for an administrative agency such as the SEC to come in and to argue, in effect, for giving up authority, and I commend you for breaking away from what I have sensed to be a bureaucratic mentality we find not only in Washington but in the States and local governments and their agencies as well, the mentality of empire building.

I'm certainly not in a position to indicate what we will eventually decide, but certainly your testimony and the unanimous recommendation of the Commission carry a great deal of weight here and will carry a great deal of weight with the full committee.

Mr. SHAD. Thank you very much, Senator.

Mr. LONGSTRETH. Thank you.

Senator D'AMATO. The next witnesses will be the Honorable William Baxter, Assistant Attorney General, Antitrust Division, Department of Justice; and Richard Schuler, deputy chairman, New York Public Service Commission, Albany, N.Y., on behalf of the National Association of Regulatory Utility Commissions.

Mr. BAXTER.

STATEMENT OF WILLIAM F. BAXTER, ASSISTANT ATTORNEY GENERAL, ANTITRUST DIVISION, DEPARTMENT OF JUSTICE

Mr. BAXTER. Thank you very much, Senator D'Amato.

We have submitted a statement of the position of the administration and the Department of Justice. I won't go through it all, on the understanding that it will be included in the record.

Senator D'AMATO. The entire statement will be included in the record as if read in its entirety.

Mr. BAXTER. With that understanding, I'll try to be as brief as possible.

Our interest in this matter is a rather complex story, but it has a straightforward bottom line. We are in favor of the repeal of the Public Utility Holding Company Act in its entirety.

On the other hand, for reasons that I will try to explain, we have some concern over the various amendments to that act which tend to leave portions of the existing statutory scheme in place.

POSSIBLE ABUSES OF DIVERSIFICATION

Our concern, if I can turn to that first, has to do with the diversification by public utility companies which are subject to cost-of-service-type rate regulation into competitive areas of the economy. I do not mean to suggest that that pattern of diversification is always undesirable. Certainly there are, in some instances, economies and cost savings associated with that kind of diversification which make the activity worthwhile. On the other hand, it also gives rise to the possibility of certain kinds of abuses.

The clearest illustration of the problem I could give you would be a utility that integrated into the manufacture of equipment which it used as a utility and then purchased the equipment from its affiliated enterprise. Since its public utility rates are set with reference to its costs, an entity which is diversified in this way is sometimes in a position to pay its affiliated enterprise very high prices for the equipment it buys from the affiliate, smuggle it into the regulated cost base and, therefore, bring about an elevation of the regulated rates themselves.

Under certain circumstances, particularly if there is not an active and open market in the commodity or service which it is purchasing from the affiliated enterprise, it can be difficult for the Public Utility Commission to identify and control that type of behavior. That, in short, is our concern.

Turning from our concern to the Public Holding Company Act itself, I would observe that although the Holding Company Act limits diversification by the subset of utilities to which it applies, it does not prohibit diversification.

FUNCTIONAL DIVERSIFICATION

The Act, as it has been interpreted by the SEC over the years, prevents public utilities from diversifying into wholly unrelated activities, but permits what the SEC calls functional diversification.

Now in my comments I don't mean to criticize that line of interpretation by the SEC. That line of interpretation made sense in view of the particular public mission of the SEC, which was to pay attention to capital structures and in particular to protect investors.

Nevertheless, it is true that that particular pattern of interpretation means that the Public Utility Holding Company Act really has very little by way of favorable impact on the situations with which we are concerned.

If a local gas distribution company integrates into the furniture business, which would be a nonfunctionally related integration, the SEC for its purposes would not permit it, but we would be relatively unconcerned by it. There is very little opportunity for self-dealing, cross-subsidization, or misallocation of common costs in a situation such as that.

On the other hand, if the public utility integrated into the coal-mining business and furnished its own fuel, the SEC would regard that as a functionally related situation and would permit that—again sensibly—from the standpoint of the interests it is attempting to effectuate.

But it is precisely those situations which the SEC has always permitted under the Public Utility Holding Company Act that we find the greatest potential difficulties in the form of antitrust problems.

In short, although the Public Utility Holding Company Act seems, on its face, to be addressed to a problem with which we do have concerns, in fact it has been and is likely to be of very little help to us in addressing those concerns.

Accordingly, it is our conclusion that we should attend to those concerns by examining situations on a case-to-case basis, as we have in the past, and by bringing the antitrust laws to bear where we perceive that there are problems. Accordingly, the Department of Justice and the administration are able to join in the recommendation that the Public Utility Holding Company Act has outlived its usefulness. The problems to which it was primarily addressed many years ago have really been taken care of; the current disclosure reporting requirements and associated changes in the capital markets are such that it is no longer needed.

We urge its repeal.

Thank you, Mr. Chairman.

[The complete statement follows:]

U.S. Department of Justice

TESTIMONY

OF

WILLIAM F. BAXTER
ASSISTANT ATTORNEY GENERAL
ANTITRUST DIVISION

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to appear before this Subcommittee to present the views of the Department of Justice on the issue of repeal or amendment of the Public Utility Holding Company Act ("Act"). A central feature of the Act is the requirement that certain electric and gas utility holding companies must obtain the prior approval of the Securities and Exchange Commission ("SEC") before making significant acquisitions. In such cases, the Department may and, on occasion, has elected to raise its concerns about the likely competitive effects of proposed acquisitions before the SEC. Accordingly, and because of our concerns about the competitive implications of utility diversification generally, the Department has a direct interest in any bill that might affect the present statutory scheme.

The Department also plays a role in formulating proposals to implement this Administration's frequently expressed commitment to removal of regulatory burdens on private enterprise whenever possible. The Department's approach to deregulation here, as in other contexts, is based on the premise that economic regulation is, at best, a poor substitute for competition and should be employed only in those relatively few situations where it yields a net improvement over the performance of the market and that improvement outweighs regulation's costs.

In this spirit we have examined S. 1869, S. 1870, S. 1871 and S. 1977, bills which would amend or repeal the Act in the following ways:

- S. 1869 would make selective, substantive changes in the Act to reduce SEC oversight to allow diversification into non-utility business interests without SEC approval for registered electric holding companies.

- S. 1870 would allow exempt companies to form exempt holding companies and would remove the SEC's discretionary authority to deny that exemption if a company diversifies.

- S. 1871 would exempt from coverage the three gas utilities now regulated under the Act.

- S. 1977 would repeal the Act in its entirety.

The Department of Justice supports S. 1977 and opposes those bills that fall short of complete repeal of the Act.

Although the Administration takes no position on the desirability of any particular utility diversification, we do want to note Justice Department concern about the competitive implications of utility diversification. Because of that general concern, we believe that partial repeal, designed explicitly or implicitly to permit and endorse diversification while leaving the Act's remaining regulatory features intact, would not be well-advised. We believe that complete repeal is less likely to be viewed as a signal encouraging diversification, and we agree with the SEC's judgment that the Act's regulatory panoply is unnecessary to serve its original purposes of protecting investors.

The SEC has expressed support for a wholesale repeal of the Act. It has concluded that new accounting methods and reporting requirements embodied in other statutes -- especially the securities laws it administers -- make the recurrence of significant abuses that would injure investors unlikely. Moreover, the Act has narrow coverage and is not applicable to the majority of utilities. Given this assessment, we share SEC's view that continued regulation cannot be justified.

Our examination of the costs and benefits of the present statutory scheme has focused primarily on the aspect of SEC regulation of most concern to the Department -- the SEC's interpretation that the Act permits registered holding companies to diversify, but only into functionally-related areas. */ For example, under this interpretation, the SEC

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*/ See Michigan Consolidated Gas Co. v. Securities & Exchange Commission, 444 F.2d 913 (D.C. Cir. 1971).

would more than likely allow an electric utility holding company to integrate upstream into its fuel supply, but disallow its acquisition of a chain of drug stores. Although we do not doubt that this line of interpretation correctly furthers the purposes of shareholder protection that the SEC is pursuing, unfortunately, this approach heightens -- rather than lessens -- our competitive concerns about diversification, because diversification into related areas is more likely to create the potential for cross-subsidization that goes undetected than is diversification into remote areas of activity.

We recognize that the financial health of the electric and gas utility industries is vital to this country's economic and social well being. Many utilities, deeply concerned about their long-term financial health, see some salvation in diversification into unregulated markets, pointing to evidence that past diversifications by utilities have, on balance, improved the financial performance of the overall firm. We are sympathetic to utilities' financial concerns and recognize the institutional difficulties that lie in the way of direct solutions. Allowed rates of return may, in many cases, be held too low by state regulation. As a consequence, many utilities are widely considered to be in poor financial condition.

Diversification, however, does not address this fundamental regulatory problem. It attempts to ameliorate it, but in doing so, may only compound it. Diversification by a regulated utility to reduce risks should be unnecessary, since rate-of-return regulation, when done properly, should compensate adequately for risks undertaken. Moreover, absent opportunities to engage in collusive or monopolistic behavior, the best a utility can hope for by diversifying into an unregulated market is a competitive rate of return. Presumably, these returns are essential to the continued success of the new, competitive venture. If properly treated by regulators, such success should not significantly affect the regulated divisions of the companies. But it is also true that diversification, if properly handled by regulators, will not be able to offset the low rates of return associated with the regulated entity. Diversification cannot succeed in solving a problem that ought to be dealt with directly -- an inability, whether actual or perceived, to earn a fair rate of return under regulation.

There is also a possibility, however, that diversification may further damage the utility's financial condition by prompting the regulator to extend regulation, directly or indirectly, over unregulated assets and activities and use them to subsidize the utility's rate payers. For example, as detailed in the Department's most recently published report on Competition in the Coal Industry, */ some state regulatory commissions have limited, in various ways, the price a utility may pay for coal purchased from its coal subsidiary to below the competitive level. This results in the inefficient subsidization of utility ratepayers at the expense of the utility and its investors.

The particular concern of the Justice Department, however, centers on the policy questions involved whenever a regulated enterprise seeks to enter an unregulated market. Such entry can be a device for circumventing rate regulation and may distort economic performance in the previously competitive market as well. To illustrate this concern, I will refer again to our recent Coal Report, in which we examined the question of regulating dealings between regulated electric utilities and their coal-producing affiliates or subsidiaries. The Report concluded that state and federal regulatory authorities are unable to cope with the complex task of regulating internal transfer prices for coal and that integration of electric utilities into coal markets is, therefore, likely to circumvent effective rate regulation. Because the regulator cannot know what a competitive, arm's-length coal transfer price would be, the utility has every

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*/ U.S. Department of Justice, Competition in the Coal Industry 57-58 (March 1982).

incentive to inflate the price it pays its subsidiary, passing on to utility ratepayers any excess costs and artificially enhancing the profitability of the coal subsidiary.

The Department's concern about regulatory evasion through utility diversification is not limited to the sort of transfer pricing problems that arise when the diversification is in a vertically related activity. Even non-vertically related diversification may raise issues of joint cost allocation between regulated and unregulated sectors, issues which may transcend the ability of regulators to recognize and deal with them.

For example, a decade of litigation against AT&T, involving many incidents where regulated and unregulated companies did business under common control, has ended with a settlement proposing corporate realignments and divestiture to an unprecedented degree. The consistent underlying theme of that settlement is a painstaking effort to separate the unregulated sections of the company from those that are regulated in order to prevent the competitive problems that occurred by reason of that common control. This will free what can be freed of AT&T to competitive forces and, by setting up independent companies, minimize the task of regulating those natural monopoly aspects of telecommunications service that must continue to be regulated.

Nevertheless, we recognize that the Public Utilities Holding Company Act has not proved an effective instrument for dealing with our concerns about diversification. As interpreted, it permits precisely those forms of diversification we find most troublesome. From the Department's perspective, the Act is not well-suited to advance antitrust enforcement policy in the regulatory context. We are prepared to deal with any increase in merger activity by regulated firms by evaluating the merits of acquisitions on a case-by-case basis under the antitrust laws. Given that the SEC is satisfied that it can adequately regulate the securities dealings of utility holding companies under other federal statutes, the Department supports repeal of the Act in its entirety.

I thank the Subcommittee for this opportunity to explain our views on these issues. I would be happy to answer any questions.

Senator D'AMATO. Thank you very much, Mr. Baxter.

LIMITS ON UTILITY DIVERSIFICATIONS

Mr. Schuler, before we get to your testimony, I'd just like to ask Mr. Baxter a few questions. Should limits be imposed on the utility diversification, either by the type of business or the percentage of assets invested, in your opinion?

Mr. BAXTER. I don't see any reason for an across-the-board and categorical prohibition on diversification by utilities. It can bring rise to problems, it can bring about economic distortions—not only in the regulated but in the associated unregulated market. But it is also true that it can give rise to economies of integration, which should not be ignored, as they would be by a categorical prohibition.

Senator D'AMATO. What considerations would be relevant in evaluating, for example, the proposed acquisition of a holding company by a major oil company?

Mr. BAXTER. Of a public utility holding company by a major oil company?

Senator D'AMATO. Yes.

Mr. BAXTER. I would not think that posed very serious problems in the absence of some features that you have not embodied in your question.

The purchase of boiler oil, which might be one of the areas of apparent concern under those circumstances, would be a very difficult context in which the affiliated enterprise could overcharge the utility because there is a very active and open market in various grades of petroleum products.

Senator D'AMATO. That's the situation today?

Mr. BAXTER. Yes; and there's no likelihood whatsoever that those markets are going to disappear. So that the large oil company would have a great deal of difficulty quoting a price of $3 a gallon for diesel fuel to the utility when anyone can look out there in the marketplace and see that everybody else is managing to buy diesel fuel at $1.10 a gallon.

The existence of active markets poses an effective check on the ability of companies to behave in that way. On the other hand, when coal is used as boiler fuel, it is often used in conjunction with the development of a particular mine, so that the utility is the only customer of a particular mine and is buying under conditions that are dissimilar to the conditions under which other utilities are buying.

The right price for coal under those kinds of mine-mouth generating arrangements is very difficult for a public utility commission to identify. On the other hand, it is not a problem that is effectively addressed by the Public Utility Holding Company Act either.

Senator D'AMATO. Mr. Baxter, in your statement you mentioned the AT&T litigation. I wonder if you can tell us in what way the issues presented by the deregulation of AT&T are similar to or are different from the issues presented by the deregulation of the utility holding companies.

Mr. BAXTER. Well, of course, as Chairman Shad pointed out, one of the oddities of the Public Utility Holding Company Act is that it does not apply to so many of our utilities, and it does not apply to the telephone utilities.

But the AT&T case is illustrative of what I have described as some of the potential problems there. The AT&T Co. by integrating into the manufacturer of complex switching equipment—just to take one particular example—supplied the great preponderance of switching equipment to the various telephone operating companies.

By effectively preempting the potentially competitive market—that is to say, the manufacture and sale of the switching equipment—it was able to prevent—or to put it less hostilely—there did not emerge an independent, active market out there which a regulator could watch.

Therefore, it was extremely difficult for the public utility commissions to have any confidence in whether the pricing of the switching equipment to the basic operating companies was at approximately competitive levels.

And, of course, the financial arrangements between Western Electric and the basic operating companies were very, very complex.

Accordingly, under the decree in that case, the whole animating philosophy of the decree is very, very careful to separate the AT&T Co. into two portions: those activities which must inherently be regulated because they exhibit strong natural monopoly phenomena, on one side, and all of the potentially competitive activities of AT&T on the other side.

Senator D'AMATO. Some of the critics of the Holding Company Act's repeal argue that unlimited diversification by utilities could lead to anticompetitive conditions in certain industries, such as in the supply and installation of energy-related products—for example, heaters, air-conditioners, conservation tools. It's argued that the sheer size of the utility, its ability to procure volume discounts, as well as the intrinsic benefits of its monopoly status would enable the utility to dominate these markets.

Now how would you respond to this argument?

Mr. BAXTER. That sometimes is a possibility. But precisely where it is a possibility, you are talking about an integration that under the Public Utility Holding Company Act would be described as a functionally related integration and therefore permitted by the SEC.

So that by longstanding interpretation, from the particular point of view that I'm speaking of, the Public Utility Holding Company Act addresses itself to precisely the wrong set of integration possibilities and is of very little help in addressing this other set of concerns.

We think they are adequately addressed under the antitrust laws, and we have recently shown that we can make the antitrust laws work in those contexts.

Senator D'AMATO. Mr. Baxter, thank you very much for taking the time to come down and give us your views on this legislation.

I think your final comment about the antitrust laws is worth noting. You are saying that repeal of the Holding Company Act would not have the effect of sanctioning anticompetitive activities, the nature of which would force the small competitor out, because the antitrust laws already prohibit this type of activity.

Thank you so much for your testimony.

Mr. Schuler, would you give us your testimony?

STATEMENT OF RICHARD E. SCHULER, DEPUTY CHAIRMAN, NEW YORK PUBLIC SERVICE COMMISSION, ALBANY, N.Y., ON BEHALF OF THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

Mr. SCHULER. Senator D'Amato, I appreciate the opportunity to appear before you to introduce the perspective of a State regulator. I am also a member of the NARUC ad hoc committee that's examining utility diversification, and I will introduce our views into your deliberations on the repeal of the Public Utility Holding Company Act.

I, too, will try to briefly summarize my testimony, recognizing that the full text will go into the record.

I probably ought to reveal that I am here under several aliases. I am also a professor of economics at Cornell University, and in a previous incarnation I was an electrical engineer working for an electric utility in the midsixties. In that respect, it's somewhat ironic for me to appear here today since one of the last memos I wrote to management strongly urged their diversification into a wide range of nonutility activities.

In New York, there are no major electric utilities that are covered by the Holding Company Act, but we do have substantial experience with interstate telephone and water utilities who are not covered by the act and we have subsidiaries of two of the three gas utilities that are covered.

And I think it might be revealing to indicate some of the difficulties we've had in regulating those noncovered utilities and to extrapolate some of the concerns that might carry over to modifications of the existing act.

It seems to me much of the debate about the 1935 act is misplaced and that there are really two overriding facts that ought to be kept in mind when we're dealing with utilities in contrast to other companies that are governed by the SEC.

First, utilities are monopolies, and monopolies can be expected to abuse their power unless they're properly regulated. Now, what's proper regulation is the issue, I think, that's under discussion here today.

Second, these are utilities that are engaged in interstate activities as contrasted with intrastate utilities. Even if you conclude that utilities should be given greater ability to diversify than they now have, you should insure that the modifications made in the act still permit effective regulation at the State level.

DESIGN A FLEXIBLE POLICY ON DIVERSIFICATION

As a member of the NARUC committee that is trying to develop an updated policy on diversification, one thing is clear to me, and that is that every State and region in the counry is different. Some States almost favor outright prohibition of diversification; others are very much in favor of diversification. It seems to me the task at hand is to design as loose and flexible a framework that can accommodate these various disparate views and at that same time still allow a Federal agency the ability to moderate disputes between the various States when there's an interstate utility operating within both those States.

Although I don't want to dwell on the pro's and con's of diversification, I can't leave the topic without pointing out one somewhat misplaced argument that I hear ballyhooed about.

I think you pointed to it directly, Senator, in the question you addressed to Chairman Shad.

That is that diversification is needed to improve the financial condition of the utilities.

Well, it may improve the financial condition of the combined entity, but it seems to me only managerial ability, the national economy, and the rate of inflation, and we, as regulators, can affect the intrinsic financial viability of the utility itself.

Obviously, if you take equal pieces of a utility that is earning a 15-percent return on investment and append that to a hula-hoop company that's earning a 25-percent return, you would expect a combined return of about 20 percent. But has that gained anything for the utility business itself? It seems to me not.

Intrinsically, there's been no change, and I think that's the thing we have to be concerned about—what really improves the utility business itself? Are we just papering over a utility's financial difficulty by allowing them to diversify, without getting at the root cause of their problems?

I note that over the recent several months, as the national inflation pictures seems to improve, so are utility finances. And I see investment counselors are once again beginning to recommend utility securities. This all seems to have come about without the benefit of widespread utility diversification.

But let me focus on the act itself. Again, keep in mind the two things that are different about covered utilities: One, they are monopolies. And second, they are interstate

It seems to me, without Federal regulation, complex interstate, multifunctional, holding companies can frustrate and preclude effective State regulation. It was really this combination of circumstances plus, in many cases, the absence of effective State regulation many years ago that led to the original act. It seems to me that the task of modifying the act is to do so in a way that still recognizes those basic needs that led to its passage but meets those concerns with as flexible and lighthanded a regulatory framework that is possible.

POWERS OF STATE COMMISSIONERS

What are our powers as State commissioners to deal with and regulate utilities?

First, is our authorization to set rates.

The second is a derivative power. If utilities provide incredibly poor and unreliable service, we and many other States have the authority to impose penalties. In a sense, that's still a ratemaking function.

The third power that's available in some States is to approve individual investments and financings made by utilities, including investments in diversified nonutility kinds of activities.

Well, now, that would seem to give us the power to correct all possible harms. But let me recite to you some of the waterfront that isn't covered and some of the difficulties that we wind up in.

The ratesetting power really is adequate so long as the utility side of the business is a substantial fraction of the entire entity. Where that gets to be a weak and sometimes meaningless power is if the utility is a very small fraction—or at least the utility operating in our State is a very small fraction of the entire entity, because then the whole holding company can engage in a wide range of strategic manipulation of the utility.

We'll say: "Gee, your service is just abominable. We want you to invest in better water supply facilities so tap water is no longer brown."

And the utility says: "We won't do it unless you double or triple our rates." So, they don't do it.

Senator D'AMATO. Commissioner, it sounds suspiciously like you have a particular company in mind.

Mr. SCHULER. I would think you may have received some mail about that company over the years.

Senator D'AMATO. That company is within the jurisdiction of which I used to be the supervisor. [Laughter.]

Mr. SCHULER. You appreciate the problem.

Our problem is——

Senator D'AMATO. Did you research that as an example? Maybe you read a book on the subject before you came here?

Mr. SCHULER. Frankly, I was aware of the problem even before—or while you were town supervisor, but before you were a Senator. This particular utility has been at least a 7- to 8-year ongoing problem.

Senator D'AMATO. They were so happy to see me leave.

Mr. SCHULER. It's a problem for regulators to get a hold on a utility like that since it may be in the company's interest to engage in a long-range strategic battle. They'll accept poor financial returns in the short run and do battle with the Commission. And this might be a nice theoretical way of resolving a conflict, but the poor customers suffer in between.

All I'm saying is that if the ratemaking power is to be an effective one, it has to be a credible threat, and that only occurs if the utility revenues represent some substantial fraction of the total business. That's avoided by diversification into large, nonutility businesses. It also may be avoided if the utility we're dealing with has a particular problem in New York State but, in fact, is part of a much larger interstate company. So, still, the entire magnitude is much larger than the part we have power to regulate.

There can also be problems for State commissions in tracing costs if the utility is an interstate operation. In a way, I am begining to think that the push for utility diversification is almost like welfare for accountants and attorneys, because the accounting and legal problems are truly complex, although not insurmountable. I think this is a policy judgment call here of what's acceptable and what isn't.

INTERSTATE CONFLICTS

Finally, it seems to me that there are the inevitable problems of interstate conflicts. If you have utilities operating in several States in a holding company format, one State may say: "I want to treat the rate of return in such a way and build a rate schedule in a certain way." Another State may want to do it in a different way. Each State may even want to impute different types of capital structures to the same interstate utility.

It seems to me that at the very least you need some single keeper of adequate records that will allow each State to do what it wants. And in the case that there is a conflict and a need for a resolution on an interstate basis, some Federal mechanism is needed to accomplish that.

The investment approval, again, gets to be a difficult task at the State level if we're faced with an interstate utility. What happens if one State approves and a second doesn't.

One thing is clear. If we allow a holding company to be built on top of the operating utility itself, we lose effective control of all subsequent investments in nonutility operations by that company. In other words, once we make the threshold decision that a holding company can go on top of the utility, then they can form many additional nonutility subsidiaries without additional State approval. The danger is that the utility end of the business may ultimately become a small fraction of the total.

So, how does the 1935 act help us? Well, so far, it helps, but with the sensitivity of a sledge hammer. It effectively inhibits diversification in nonutility businesses although, as Mr. Baxter points out, in fact, diversification is permitted under the act.

Second, the SEC does review financing. And again, the fact that they may do it on a case-by-case basis may inhibit utilities from going into diversified activities.

Third, they do approve affiliate transactions, which I acknowledge is redundant, at least for the electric and gas companies, since FERC also provides that kind of an overview.

So, I guess what I come down to is what's required on the Federal level. And I'd like to summarize it in a way as three R's. Two of them are reviews.

One, to continue to review individual utility financings with an opportunity, an open period, for States to comment. If no comments come in, fine, it goes through automatically.

The second, more important review is of investments. And here I see two distinctions. I can appreciate that if I'm a utility and want to go into a nonutility diversified venture, the last thing I want to do is to reveal all my detailed business plans to my potential competitors. And so I would advocate that for nonutility ventures what's required is merely to file a broad, general diversification plan. As an example: We plan to put in 10 percent of our assets in the coming year into nonutility ventures, and they are going to be essentially consumer goods operations.

In the case of investments in what's termed "affiliate transactions," I think a more detailed review is necessary, because there's the opportunity to exploit ratepayers in the charges for transactions that take place between a utility and its related supplier. But again, I think that could be handled through FERC and its kinds of procedures.

The third R is the assurance that there's some common place where records are kept in adequate fashion so the State commissions can have ready access to them so they can make their own independent deliberations and determinations on rates and ratebase issues.

Now, it seems to me that these three functions have to be preserved somewhere at the Federal level. Whether it ought to be in the SEC or it ought to be in FERC, I am not sure—although I have a funny feeling that the utilities would much prefer to see it at the SEC than in FERC—but it seems to me that those functions have to be preserved at some place.

Now, let me just conclude that whatever decision you ultimately reach, the States should be granted a 12-month adjustment period between the enactment of legislation and the time that it would actually go into effect, so that we would have the opportunity to make whatever modifications might be necessary to State law.

[The complete statement follows:]

TESTIMONY OF DR. RICHARD E. SCHULER, COMMISSIONER AND DEPUTY CHAIRMAN, NEW YORK STATE PUBLIC SERVICE COMMISSION

Mr. Chairman and members of the Committee, I welcome the opportunity to introduce the perspective of a state regulator and NARUC committee member into your deliberations on the fate of the Public Utility Holding Company Act. I also have several aliases: as a Professor of Economics at Cornell University, and in a previous incarnation as an electric utility engineer.

In New York there are no major electric utilities covered by the Act, but subsidiaries of two interstate gas holding companies—National Fuel Gas Company and Columbia Gas System, Inc.—come under our jurisdiction. We do have substantial experience in regulating private water and telephone companies who are part of larger interstate holding entities. While these utilities are not covered by the 1935 Holding Company Act, our experience in regulating them should offer instructive examples of problems that could arise and should be avoided when the 1935 Act is modified.

Much of the debate about the 1935 Act seems to me to be misplaced. Two facts should be kept in mind: first, utilities are monopolies and monopolies can be expected to abuse their power unless properly regulated. Second, these utilities are engaged in interstate activities and thus can escape effective regulation at the State level. Even if you conclude that utilities should be given greater flexibility to diversify, you must insure that whatever modifications are made to the Act still permit effective regulation.

As a member of the NARUC Ad Hoc Committee that is developing an updated policy statement on utility diversification, one thing is clear to me: every state and region of the country has a slightly different perspective on the merits of diversification. Many states are strongly in favor while others prefer outright prohibition. Your Committee probably should not try to settle these differences. Rather, the task you face is to design legislation that provides the necessary framework for states to regulate utilities as they deem necessary. You must allow effective safeguards against monopoly abuses without establishing regulatory requirements that are—as one witness at the recent NARUC hearings termed them—overly hostile, grasping, and restrictive.

I cannot leave this topic without allowing my pedagogical instincts to get the better of me. I note that some proponents in favor of repealing the Act argue that none of the undesirable practices which originally precipitated its passage are now prevalent. This strikes me as a bit of disingenuous. It is similar to arguing, after having incarcerated all criminals, that if we observe no further street crime, we could safely dismantle our system of criminal justice.

Another argument made in favor of diversification—that it will improve the financial condition of the utilities—is misleading. Only utility management, the overall well-being of the national economy (inflation in particular) and regulators can improve the financial condition of utilities. What diversification may allow is for the utilities to paper over and disguise the root causes of their financial difficulties, not cure them. Obviously, if you combine equal parts of a hula-hoop company earning a 25% return with an electric utility earning a 15% return, the combination may be able to earn a 20% return. The diversified utility may appear to have a better earning record even if there has been no real improvement in the operation of either of the two companies. In some instances, diversification may even result in ratepayers of a regulated utility being burdened with additional expenses. For example, in New York, we recently faced the unpleasant task of providing extraordinary rate relief to a water utility solely because it was a subsidiary of a holding company. Because of the many bad non-utility investments and therefore drained financial condition of the holding company, needed utility plant could not be financed without unreasonably large water rate increases.

In fact, over the past several months there are signs that the financial health of many utilities is improving. Utility securities are beginning once again to gain favorable attention from investment advisors. This is largely due to changes in the fundamental sources of the utilities' financial strength and has little to do with utility diversification.

However, I am not here today to debate the pros and cons of utility diversification. As an economist and regulator I believe the Act could be modified, but as I stated earlier, any analysis of the Act must recognize two uncontroverted facts. One, regulated utilities are natural monopolies who, without government oversight, would have the capacity to exploit their customers unfairly through their monopoly power by price gouging and restricting service. Parenthetically, I note that some of the impetus for diversification comes from utilities who may no longer possess this natural monopoly characteristic; the preferred treatment in those instances is to deregulate, not diversify, those operations. Second, without Federal regulation, complex interstate, multi-functional holding companies can frustrate and preclude effective State regulation. It was this combination of circumstances, plus the absence of State regulation in some instances, that led to the original Act of 1935.

The task at hand is to modify the 1935 Act in a way that still recognizes the basic needs that led to its passage but meets those concerns with as flexible and light-handed a regulatory framework as is possible. The types of modifications that can be made to the 1935 Act without crippling the effectiveness of State regulation are in turn dependent upon the adequacy of State law. Let me address that issue next.

I. REGULATORY DEVICES CURRENTLY AVAILABLE TO MOST STATE COMMISSIONS

The dominant tool available to states for regulating their utilities is the authority to set rates. In many cases, State regulators may also invoke penalty actions for inadequate utility performance, including continued poor service. In order for either of these regulatory instruments to be effective in motivating utilities, however, the utility operation must represent a substantial fraction of the overall entity's earnings. If the potential loss incurred on the utility side of the business is a relatively insignificant portion of the whole, the holding company may choose to engage in a strategic contest and provide ever poorer service in response to commission efforts to penalize it for past poor performance.

A third regulatory tool available to many commissions, is the authority to approve long-term financing by utilities in their state. This offers regulators effective authority to approve large utility construction programs. Several states also grant their commissions explicit authority to approve utility investments in non-utility projects. But this authority may be quite limited. If, as an example, the utility itself is the holding company that establishes non-utility subsidiaries, the subsidiaries themselves may be able to form other subsidiaries without additional Commission approval. By comparison, if the state commission approves a holding company umbrella, with the utility as a subsidiary, then the Commission loses control of the number of subsequent non-utility subsidiaries that are established by the holding company. In recent New York State practice, we have preferred to have the utility as the holding company, under the theory that this structure affords us somewhat better monitoring ability.

II. AUGMENTATION OF STATE COMMISSION AUTHORITY THROUGH THE 1935 PUBLIC UTILITY HOLDING COMPANY ACT

The 1935 Act precludes many of the potential problems of large diversified interstate utilities by imposing extensive reporting requirements, prior approval on diversification, and SEC authority to order divestiture. The utilities feel these requirements severely restrict diversification. The relevant question for you is whether such sweeping restrictions continue to be necessary. A problem under the Act is that interstate holding companies are treated differently than many of their intrastate brethren. It does not follow, however, that the best way to resolve problems raised by this asymmetrical regulatory treatment is simply to abandon Federal regulation.

The 1935 Act requires the SEC to explicitly approve all financing by non-exempt holding companies. Where State commissions also have this authority the need for SEC approval may seem, at first glance, redundant. In fact, the SEC's primary responsibility is to protect investors from management manipulations. State regulators, on the other hand, are primarily concerned with insuring that utility service is provided to customers at reasonable and non-discriminatory rates. While some consolidation and standardization of filings may be possible, you should not assume that the responsibilities, and hence the information requirements, of the SEC, FERC, and State regulators are the same.

However, since FERC reviews and regulates the terms of all fuel and energy transfers between interstate affiliates, there is no need for the SEC to oversee these transactions.

III. REMAINING REGULATORY PROBLEMS IF THE 1935 HOLDING COMPANY ACT IS REPEALED

Even if individual State regulatory commissions have the authority to approve financings, a large interstate holding company can circumvent this regulation by raising funds through the holding company, not the subsidiary. This problem is partially avoided at present because the SEC has authority to review all financings by the holding company, although this review often comes after the initial investmnent has been committed. The problem cannot be completely avoided unless the SEC is also given authority to review all investments, not just financings, in non-utility businesses since some significant investments are made without financings. I recommend that utility holding companies be required to file their investment plans with the SEC, but that approval of those plans be automatic unless an affected State objects to the company's diversification program. In those situations where some States approve and others object to the investment plan of an interstate holding company, the SEC would become the true Federal arbitrator of differing State views.

The second major concern of States is to assure effective and not overly costly access to a holding company's books. It is impossible to overstate the importance of this issues. One reason why it is essential for the State commission staffs to inspect the records of affiliates is to insure that the public is not harmed by transactions between the utility and holding company affiliates. Note that this is an important concern only where a utility, who by definition is not disciplined by the competitive market, is a party to these transactions. Similarly, different decisions by individual States regarding utility diversification will have implications for the capital structure to be used for rate setting purposes. Again, access to the appropriate books is necessary to determine how to impute the correct capital structure and costs. Therefore, there should be a centralized record-keeping activity within the SEC for interstate utility holding companies.

The third and most important unresolved problem arises if interstate utilities are allowed to diversify into non-utility operations: how do we insure that the utility side of the business remains a signficant fraction of the whole so that State regulatory actions get the attention of the holding company? I believe that the least intrusive way to do this is to require a periodic overview of a utility's broad strategic diversification plans. For example, if the SEC continues to approve the individual financings, or better still, the total investments, of these holding companies, and if a review process is required, then individual States would have an opportunity to voice their concerns.

Needless to say, the utilities wish to shed all review of their diversification plans. Except in the case of affiliated transactions that might be reviewed by FERC, detailed regulatory review on a case by case basis is probably not warranted for non-utility related diversification. However, a review of the general scope of the diversification plans may provide the necessary check on the overall extent of non-utility activities, and therefore on the effective ability of the holding company to circumvent State regulation.

IV. CONCLUSIONS

Whatever modifications are made in the act, I urge that you institute a twelve month transition period between the enactment and effective dates of those changes. This would give State legislatures the needed time to consider modifications of regulatory powers and procedures in their own jurisdictions.

Also, while changes in the act may remove an asymmetry between the ability of interstate and intrastate gas and electric utilities to diversify into non-utility ventures, one anomaly remains: interstate water, sewer and telephone utility holding companies, those who have caused the New York Commission a great deal of recent difficulty, are not covered by the act. Shouldn't the act, when modified, be extended to cover all interstate utility holding companies?

Any modifications made to the 1935 act must recognize that only the Federal Government has the authority to maintain adequate regulation over interstate monopolies. Although it does not appear fair to preclude interstate gas and electric utilities from engaging in non-utility diversified activities (and indeed they are not strictly prohibited from doing so under the existing act); nevertheless, any Federal legislation to ease this type of diversification should retain three review procedures at the Federal level. First, the SEC should continue to approve new financing by these interstate companies. Second, a periodic review should be made of these holding companies' diversification plans, including a review of their total investment in non-utility businesses. In both of these circumstances, individual State commissions should be afforded the opportunity to express their views on the holding company activities. Third, it should be the responsibility of the SEC to see that the books and records are kept on a conformable basis and in a central location that is reasonably accessible to all State commissions. This is necessary so that the various State commissions will have information needed to unravel transactions and to estimate the capital structure for rate setting purposes.

While it is true that this type of reporting is not required of non-utility holding companies, those corporations must ultimately meet a market test on the goods and services they provide. Thus there is a limit to the impact of managerial error or exploitation; they cannot hold their customers captive because the consumers can turn to competitors. That is not true in the case of utilities. If their diversification plans go sour, utility ratepayers will eventually be hurt. It is because regulated utilities and utility-related holding companies have a unique potential for exploiting the public that additional reporting and approval procedures should be required in exchange for the freedom to diversify into non-regulated activities.

Senator D'Amato. I'd like to ask Mr. Baxter to comment on your last proposal.

Mr. Baxter. The notion of enacting the law, but then in having a 12-month effective date? I think that makes a lot of sense, Mr. Chairman.

I can see various respects in which the States might want to adopt their laws to the new reality. In my view, the new reality doesn't differ significantly from the old, but it may now be more apparent that some of the States need to make changes.

CONSUMER AND INVESTOR PROTECTION

Senator D'Amato. At the risk of being somewhat parochial, Mr. Schuler, what protection has the act provided to the consumer and the investor of the water company which is a small part of another operation today?

Mr. Schuler. In fact, it didn't, because it's not covered by the act, and I cite it as an illustration.

Senator D'Amato. Of water companies evading effective State regulation?

Mr. Schuler. Of what might happen if coverage of electric and gas companies is eliminated?

Now, on the one hand, it seems very useful to have made that distinction historically between electric and gas, because they represent such a much larger fraction of the consumers' budgets than those other utilities did in the past. Water bills are getting to be fairly large, and we do have a number of them approaching the level of electric and gas bills.

Senator D'AMATO. Well, then why, in your view, is the Holding Company Act necessary for the regulation of electric and gas utilities but not for other kinds of utilities, such as water?

Mr. SCHULER. I would say the only distinction is the relative ability to exploit consumers, given the relative fraction of their budgets, that those——

Senator D'AMATO. Has there been a high dollar volume?

Mr. SCHULER [continuing]. And water seems to be escalating very rapidly.

I would certainly—if you like tidiness, I would call for some symmetry here, and it seems to me that the SEC either ought to be overseeing all of these utilities, including water and telephone, or perhaps none of them, in which case those functions should be transferred to some other——

Senator D'AMATO. I think John Shad just left. [Laughter.]

Mr. Baxter, what would you say in response to that contention?

REPEAL OF ACT NECESSARY

Mr. BAXTER. I think I implicitly have already agreed with that proposition. I don't think the SEC is the right agency, I don't think the interpretation that the SEC has given the Public Utility Holding Company Act over the years ever did seriously address the kind of problems that I alluded to and to which Mr. Schuler is alluding to.

And it makes no sense to keep the Public Utility Holding Company Act out of deference to those problems. To some extent, I think, they can be addressed as antitrust problems or maybe some other solution is necessary. But the Public Utility Holding Company Act is not the solution, has never been the solution, and it will not be the solution in the future.

Senator D'AMATO. I think Mr. Schuler is trying to say that repeal of the act presents the danger of exacerbating the situation by allowing unrestrained diversification, particularly into nonutility businesses—that this may lead to the diversion of resources, management, and attention from the utility. This really comes down to a fundamental question: Does the act, by prohibiting or making difficult this kind of diversification, continue to serve a public purpose?

Is that a fair analysis?

Mr. SCHULER. I think so. I agree that probably the spirit and the thrust of the SEC has not been to deal with these problems. On the other hand, it seems to me there is no other Federal agency that's particularly geared for it either.

FERC does electric and gas, but doesn't worry about telephone or water utilities. We're really talking about an interstate utility regulation problem, and so that perhaps the SEC is the best vehicle to retain any residual oversight and recordkeeping function at the Federal level.

Senator D'AMATO. I'd like to thank both of you for your testimony. I think you have raised some points that are important for the subcommittee to consider in its deliberations.

Thank you for your participation.

I now call the next panel: Mr. Vince Stanley and Mr. Leonard X. Farbman.

Mr. Stanley?

STATEMENT OF VINCE STANLEY, V. J. STANLEY, INC., ROCHESTER, N.Y., ON BEHALF OF THE AMERICAN SUPPLY ASSOCIATION

Mr. **Stanley**. Mr. Chairman, my name is Vince Stanley. I'm here today on behalf of the New York State Plumbing and Heating Wholesalers and the American Supply Association. I'm president of V. J. Stanley, Inc., a specialty plumbing supply house in Rochester, N.Y.

I'm also a member of the following organizations: The National Association of Wholesalers Distributors, the National Federation of Independent Businesses, the National Small Business Association, the National Family Council, the National Chamber of Commerce, the Rochester Chamber of Commerce, the Small Business Council of Rochester, and many trade and technical organizations.

The New York State Plumbing and Heating Wholesalers is one of nine regional organizations which comprise the American Supply Association. The American Supply Association is the single national association representing the plumbing-heating-cooling-piping wholesalers. The 3,000 members are primarily small family-owned, wholesale distribution firms. My customers are the contractors that install and service plumbing, cooling and heating products and systems, and those institutions which utilize pipes, valves, and fittings.

The range of products which we handle include water heating, solar hot water, hydronic heating, water conditioning, controls, and other mechanical products.

The failure rates of these contractors—our customers—is up substantially. Many others are closing shop on their own. I am here today—and I feel alone in opposition to legislation which would amend or repeal the Public Utility Holding Company Act and as a result encourage further utility diversification into the plumbing-heating-cooling and energy conservation supply industry.

REPEAL WOULD FURTHER EXACERBATE SERIOUS SITUATION

Diversification would have an adverse effect on competition in the plumbing-heating-cooling and energy conservation fields. Additionally, it would encourage utilities to diversify into an area where they lack the necessary expertise to function efficiently.

I realize that utilities today are able to diversify to some extent under existing laws. However, relaxation or repeal of the restrictions in the use of the holding company structure contained in the PUHCA would further exacerbate an already serious situation.

I would like to take a minute to discuss with the committee what the role of the wholesaler distributor supplier is, and specifically who the plumbing-heating-cooling-piping wholesaler is.

Most people understand the function which the manufacturer, retailer, and contractor has in our economic system, but few understand the function of the wholesaler.

The wholesaler-distributors distribute every conceivable type of consumer and industrial product. The wholesaler purchases goods from manufacturers and sells them to the retailer and industrial, institutional, commercial, and other users.

Wholesalers are predominantly small- and medium-sized businesses. In 1981 the wholesale segment of the economy was responsible for $1 trillion in sales.

The wholesaler is an expert in his commodity field. We are a wholesaler with an unusual amount of knowledge of products, parts and accessories, and an extraordinarily large inventory in our specialized lines.

We service what we sell, we guarantee for 1 year the service on all the products that we sell to our customers, the contractors. We deal primarily with the manufacturer.

When the utility enters the supply market, because of their size, they can deal directly with the manufacturer and bypass the supplier, and consequently the wholesaler.

The plumbing wholesaler is not a big businessman. For example, V. J. Stanley, Inc., has approximately 500 customers. Our volume is 2,735,000. We are located in the heart of the Rochester business district; we have 11 regular and 1 part-time employees. We have 15 plumbing wholesale competitors, 13 heating equipment competitors, and 8 control competitors.

We welcome competition in our industry; we urge new business to start up and compete with us—competition is healthy for our industry and for the American free enterprise. The plumbing-heating-cooling-piping supply industry has been built through initiative, hard work, entrepreneurial spirit, and fair competition.

However, competition is only beneficial when all the players share the common attributes. At the local level when a utility enters the supply and service market, their massive economic advantage, subsidized through their rates and optimum position in the marketplace, does not further competition.

I realize that there are those who believe that the utilities would diversify into the big-ticket items: coal and mineral exploration, petroleum production, computer services and real estate development, et cetera.

But I believe the utility will move first into those areas which are most convenient and familiar: for example, the supply and installation of heating, cooling and energy conservation systems and products.

The plumbing-heating-cooling-piping wholesaler supplier could well be the first victim of unrestricted utility diversification.

We have to compete with the utilities all the time. Increasingly, the utilities are marketing and supplying heating, cooling and energy conservation systems and products. Because of the existence of the PUHCA however, utilities must conduct their nonenergy producing activities within the geographical bounds of their State and either within their existing utility structure or as a subsidiary operation.

Under the present system we win a few and lose a few. Any removal of the barriers in the Public Utility Holding Company Act will only serve to aggravate and compound the situation. An immediate removal of these barriers could have a disastrous effect.

MONOPOLY GUARANTEED RATE OF RETURN

The advantage that a utility has is awsome in comparison to the supplier. The utility is a regulated monopoly with a guaranteed rate of return. The utility can rely on its rate base to finance and subsidize outside ventures. The utility's incentive for cross-subsidization is both an attractive one as well as one that has more and more been tolerated and encouraged by regulators and legislators.

Financially, without cross-subsidization the utility would not be able to compete because the utility's actual costs could make the cost for supply and service to the consumer too high to be practical.

Until the local utility went out of the retail business a couple of years ago we sold Rochester gas and electric products for over 20 years. Because of their high overhead we have learned that their cost to the consumer in all cases was higher than the average cost for the same product from heating and plumbing contractors.

For example, in the case of water heaters, it would be our estimate that over 50 percent of the water heaters sold by contractors—plumbing and heating—would be anywhere from 5 to 20 percent lower than the utility for the same product. Since they stopped selling on a retail basis, I would estimate that the average price of water heaters sold by contractors would be in the same category, if not lower.

As we all know, overhead for small businesses is substantially lower than utilities. Consequently, the utilities' prices for labor and material are higher unless subsidized.

Again, in Rochester, installation of water heaters sold by utilities was performed by subcontractors—plumbers, who could install for less costs than the utility personnel.

ENVIABLE MARKET POSITION

The utility can finance ventures through the use of its finance credit available as a regulated monopoly or by direct loans to the venture.

Even with all of the financial problems the utilities face today, $1 million in direct funding or guarantees to a new venture is a drop in the bucket to the utility.

I wish I would have had $1 million grubstake with which to start my business. If the utilities' venture does not succeed, the financial loss is absorbed by the utility ratepayer.

If the venture succeeds, the investor enjoys the profits. In the case of the independent businessman, success or failure is borne by the businessman, and maybe its shareholders—usually family and friends.

The utility enjoys an enviable market position with an entree into almost any household in the community. This entree gives the utility first crack at supply and service.

A subsidiary which shares the use of the utilities' name also enjoys the same entree.

The utility is often the first place that homeowners will call for service or information on purchasing and use of equipment. If for example the utility is involved in the sale of water heaters and John Q. Public calls the utility for a suggestion on where to purchase a replacement water heater, where do you think he will be referred?

The utility with its financial resources and convenient monthly billing service can offer the consumer terms on purchase which I can't match.

For instance, Wisconsin Power & Light has been selling solar water heater units at $1 over cost. Northwest Natural Gas has been selling and installing gas water heaters and providing a $150 rebate.

There is little remaining to protect the plumbing-heating-cooling-piping supplier from utility competition. PUHCA has been the principal protection.

Since the Act was passed in 1935, it has served to limit the activities of the utility. To those which are functionally related to producing energy and within the state of operation, the disincentives in the Act to utility diversification have served to restrict the utility to its main task of producing energy and supplying that energy to commercial, industrial and residential users.

The Public Utility Holding Company Act has effectively forced the utilities to diversify within their existing structure and to deal with the State Regulatory Commission in this regard.

The role of the State Regulatory Commission has been to protect the public interest, primarily the interest of the ratepayer. The Public Service Commission, however, has rarely addressed the question of competition.

In your home State of New York, Senator D'Amato, a proceeding is pending before the State Public Service Commission on behalf of Long Island Lighting Co. The Long Island Lighting Company has petitioned the authority to create a subsidiary, the Long Island Lighting Co. Energy Systems, and provide financing or guarantees to the Long Island Lighting Co. Energy Systems of up to $1 million.

Although the Long Island Lighting Co. Energy Systems would be in direct competition with suppliers and contractors, the commission has determined that the question of competition has no bearing on the procedures.

While the State Regulatory Commissions are by no means an absolute protector of the public interest under the PUHCA, as evidenced in New York, they at least have a role in reviewing diversification.

This role provides at least a forum for the consumer and the small businessman. The repeal of the Public Utility Holding Company Act would put many activities of the utility outside the jurisdiction of the State Commission.

There are some who say that the question of competition is addressed under the National Energy Conservation and Policy Act, which creates the residential conservation service program.

The National Energy Conservation Policy Act does place restrictions on utility supply and installation of energy conservation systems and products.

However, the Department of Energy's liberal interpretation of waiver and exemption provisions for utility supply and installation have to a great extent allowed for full utility involvement.

Additionally, the National Energy Conservation Policy Act statutorily does not deal with such items as gas water heaters and replacement heating equipment, to name just two items.

I would point out to the committee that the intent of the Congress, as evidenced in the legislation enacted in the NECPA, was to insure that small and independent contractors and suppliers would continue to have the ability to compete.

I would urge the committee to keep that intent in mind and to reaffirm the position in any legislative consideration.

Our major fear is that repealing or substantially amending the Public Utility Holding Company Act will result in a scenario such as the following: A utility will create a holding company which will in turn create a subsdiary for the supply and service of plumbing-heating-cooling-piping products and systems.

This subsidiary, while sharing the resources and identity of the utility, will be outside the jurisdiction of the State regulators, outside the jurisdiction of the SEC, and outside the jurisdiction of the DOE under the NECPA.

In this situation, the small supplier's only alternative would be the courts at huge legal fees which few would be able to afford.

In this scenario, the subsidiary of the holding company can enjoy the identity of the utility. The subsidiary's overhead would continue to be subsidized by the utility and the ratepayer. A subsidiary will become the beneficiary of referrals and work generated by the utility.

The business that I am in is not a simple business. Success requires an intimate knowledge of plumbing, heating, and cooling systems. While the utilities have an ability to market their products and services without training, they lack necessary expertise in many cases.

In Rochester, in spite of the fact that the local public utility was selling water heaters, they never attained the complete expertise in handling entire systems and the ability to handle plumbing problems that related to the installation of hot water equipment. They depended upon the outside contractor to do this work for them.

The prospects for failure in this field by the utility are very real, as mentioned. In a failure, the ratepayer pays the cost; when in a success it's the investor and not the ratepayer who benefits.

Mr. Chairman, while there may be changes required in the Public Utility Holding Company Act to eliminate many of the regulatory burdens, I don't see it as in the public interest to allow and to encourage further utility diversification.

Diversification will have a negative effect on competition by allowing the protected position and benefits of the utility monopoly to be utilized in nonutility fields.

We urge that as long as utilities enjoy a protective monopoly status, that their functions be limited to producing energy.

If utilities are allowed to diversify into heating, solar, hot water, they will force many marginal wholesalers and contractors out of the business.

Thank you.

[Complete statement follows:]

Statement of
Vince Stanley
of V. J. Stanley, Inc.
Rochester, New York

For The
American Supply Association

Before The
Subcommittee on Securities
of the
Senate Banking, Housing and Urban Affairs Committee

on the Public Utility Holding Company Act
June 8, 1982

Mr. Chairman, My name is Vince Stanley and I am here today speaking on behalf of the New York State Plumbing and Heating Wholesalers and the American Supply Association. I am president of V. J. Stanley, Inc., a specialty plumbing supply house in Rochester, New York. I am also a member of the following organizations:

National Association of Wholesaler/Distributors
National Federation of Independent Business
National Small Business Association
National Family Business Council
National Chamber of Commerce
Rochester Chamber of Commerce
Small Business Council of Rochester

and many trade and technical organizations.

The New York State Plumbing and Heating Wholesalers are one of nine regional organizations which comprise the American Supply Association. ASA is the single, national association representing the plumbing-heating-cooling-piping wholesaler. The 3,000 members are primarily small, family-owned wholesale distribution firms.

My customers are the contractors that install and service plumbing, cooling and heating products and systems, and those institutions which utilize pipes, valves and fittings. The range of products which we handle include water heating, solar hot water heating, hydronic heating, water conditioning, controls, and other mechanical products. Failure rate these contractors is up substantially. Many others are closing shop on their own.

I am here today in opposition to legislation which would amend or repeal the Public Utility Holding Company Act and as a result encourage further utility diversification into the plumbing, heating, cooling and energy conservation supply industry. The American Supply Association believes that to encourage diversification is not in the public interest. Diversification would have an adverse impact on competition in the plumbing, heating, cooling and energy conservation fields. Additionally, it would encourage utilities to diversify into an area where they lack the necessary expertise to function efficiently.

I realize that utilities today are able to diversify to some extent under existing law. However, relaxation or repeal of the restrictions on the use of the holding company structure contained in the PUHCA would further exacerbate an already serious situation.

I would like to take a minute to discuss with the Committee what the role of a wholesaler-distributor-supplier is and specifically who the p-h-c-p wholesaler is. Most people understand the function which the manufacturer, retailer or contactor has in our economic system but few understand the function of the wholesaler.

Wholesalers distribute every conceivable type of consumer and industrial product. The wholesaler purchases goods from manufacturers and sells them to retailers and industrial, institutional, commercial and other users. Wholesalers are predominantly small and medium-sized businesses. In 1981, the wholesaler segment of the economy was responsible for $1 trillion in sales.

The wholesaler is an expert in his commodity field. We are a wholesaler with an unusual amount of knowledge of products, parts and accessories; and an extraordinarily large inventory in our specialized lines. We service what we sell. We guarantee for one year the service on all the products that we sell to our customers - the contractors. We deal primarily with the manufacturer. When the utility enters the supply market, because of their size they can deal directly with the manufacturer and by-pass the supplier.

The p-h-c-p wholesaler is not a big businessman. For example, V. J. Stanley, Inc. has approximately 500 customers. Our volume is $2,735,000.00. We are located in the heart of the Rochester business district. We have eleven regular and one part-time employees. We have fifteen plumbing wholesale competitors; thirteen heating equipment competitors; and eight control competitors.

Competition

We welcome competition in our industry. We urge new businesses to start-up and to compete with us. Competition is healthy for our industry and for the American free enterprise system. The p-h-c-p supply industry has been built through initiative, hard work, the entrepreneurial spirit and fair competition.

However competition is only beneficial when all of the players share commmon attributes. At the local level, when a utility enters the supply and service market, their massive economic advantage subsidized through their rates and their optimal position in the marketplace does not further competition.

I realize that there are those who believe that the utilities would diversify into the "big ticket" items: coal and mineral exploration, petroleum production, computor services, and real estate development. But I believe a utility will move first into those areas which are most convenient and familiar -- for example, the supply and installation of heating, cooling and energy conservation systems and products. The p-h-c-p wholesaler supplier could well be the first victim of unrestricted utility diversification.

We are having to compete with the utilities all of the time. Increasingly, the utilities are marketing and supplying heating, cooling and energy conservation systems and products. Because of the existence of the PUHCA however, utilities must conduct their non-energy producing activities within the geographical bounds of their state and either within their existing utility structure or as a subsidiary operation. Under the present system, we win a few and lose a few. Any removal of the barriers in PUHCA will only serve to aggravate and compound the situation. An immediate removal of these barriers could have a disastrous effect.

The advantage that the utility has is awesome in comparison to the supplier. The utility is a regulated monopoly with a guaranteed rate of return. The utility can rely on its rate base to finance and subsidize outside ventures. The utility's incentive for cross-subsidization is both an attractive one as well as one that has more and more been tolerated and encouraged by regulators and legislators. Financially, without cross-subsidization, the utility would not be able to compete, because the utility's actual costs would make the cost for supply and service to the consumer too high to be practical. Until the local utility went out of the retail business a couple of years ago, we sold Rochester Gas & Electric products for over twenty years. Because of their high overhead, we have learned that their cost to the consumer in almost all cases was higher than the average cost for the same product from heating and plumbing contractors. For example, in the case of water heaters, it would be our estimate that over fifty percent of the water heaters sold by contractors - plumbing and heating - would be anywhere from 5% to 20% lower than the utility for the same product. Since they stopped selling on a retail basis, I would estimate that the average price on water heaters sold by contractors would be in the same category, if not a little lower.

As we all know, overhead for small business is substantially lower than utilities - consequently utility prices for labor and material are higher - unless subsidized. Again, in Rochester, installation of hot water heaters sold by utility was performed by subcontractors - plumbers who could install for less costs than utility personnel.

The utility can finance ventures through use of its financial credit available as a regulated monopoly or by direct loans to the venture. Even with all of the financial problems the utilities face today, a million dollars in direct funding or guarantees to a new venture is a drop in the bucket to the utility. I wish I would have had a million dollar grub stake with which to start my business.

If the utility's venture does not succeed, the financial loss is absorbed by the utility's ratepayers. If the venture succeeds, the investors enjoy the profits. In the case of the independent businessman, success or failure is borne by the businessman and maybe his shareholders - usually family and friends.

The utility enjoys a enviable market position with an entree into almost every household in the commmunity. This entree gives the utility first crack at supply and service. A subsidiary which shares the use of the utility's name also enjoys this entree.

The utility is often the first place that homeowners will call for service or information on purchasing end-use equipment. If, for example, the utility is involved in the sale of water heaters and John Q. Public calls the utility for a suggestion on where to purchase a replacement water heater, where do you think he will be referred?

The utility with its financial resources and convenient monthly billing service can offer the consumer terms on purchases which I can't match. For instance, Wisconsin Power and Light has been selling solar water heater units at $1.00 over cost. Northwest Natural Gas has been selling and installing gas water heaters and providing a $150 rebate.

There is little remaining to protect the p-h-c-p supplier from utility competition. The PUHCA has become the principal protection. Since the Act was passed in 1935, it has served to limit the activities of the utilities to those which are functionally related to producing energy and within the state of operation. The disincentives in the Act to utility diversification have served to restrict the utility to its main task of producing energy and supplying that energy to commercial, industrial and residential users.

The PUHCA has effectively forced the utilities to "diversify" within their existing structure and to deal with the state regulatory commission in this regard. The role of the state regulatory commission has been to protect the public interest--primarily the interest of the ratepayer. The public service commissions have rarely however addressed the question of competition. In your home state of New York. Senator D'Amato, a proceeding is pending before the State Public Service Commission on behalf of Long Island Lighting Company. LILCO is petitioning for the authority to create a subsidiary, LILCO Energy Systems and to provide financing or guarantees to LILCO Energy Ststems of up to $1,000,000. Although LILCO Energy Systems would be in direct competition with suppliers and contractors, the Commission has determined that the question of competition has no bearing on the proceeding.

While the state regulatory commissions are by no means an absolute protector of the public interest under the PUHCA as evidenced in New York, they at least have a role in reviewing diversifications. This role provides at least a forum for the consumer and the small businessman. Repeal of the PUHCA would put many activities of the utility outside the jurisdiction of the state commissions.

There are some who say that the question of competition is addressed under the National Energy Conservation and Policy Act which created the Residential Conservation Service program. NECPA does place restrictions on utility supply and installation of energy conservation systems and products. However, DOE's liberal interpretation of waiver and exemption provisions for utility supply and installation have to a great extent allowed for full utility involvement. Additionally, NECPA statutorily does not deal with such items as gas water heaters and replacement heating equipment to name just two items.

I would point out to the Committee, that the intent of the Congress as evidenced in the legislative history of NECPA was to ensure that small and independent contractors and suppliers would continue to have the ability to complete. I would urge this Committee to keep that intent in mind and to reaffirm that position in any legislation considered.

Our major fear is that a repeal or substantial amending of the PUHCA will result in a scenario such as the following:

> A utility will create a holding company which will in turn create a subsidiary for the supply and service of p-h-c-p products and systems. This subsidiary, while sharing the resources and identity of the utility will be outside the jurisdiction of the state regulators, outside the jurisdiction of the SEC and outside the jurisdiction of the DOE under NECPA. In this situation the small suppliers only alternative will be

the courts and huge legal fees which few will be able to afford.

In this scenario, the subsidiary of the holding company can enjoy the identity of the utility, e.g. LILCO Energy Systems. The subsidiary's overhead would continue to be subsidized by the utility and the rate payer. The subsidiary would become the beneficiary of referrals and work generated by the utility.

Utilities in Heating, Cooling and Energy Conservation

The business that I am in is not a simple business. Success requires an intimate knowledge of plumbing, heating and cooling systems. While the utilities have an ability in marketing their products and services, without training, they lack the necessary expertise.

In Rochester, in spite of the fact that the local utility was selling water heaters, they never attained the complete expertise in handling entire systems and the ability to handle plumbing problems that related to the installation of hot water equipment. They depended upon the outside contractor to do this work for them.

The prospects for failure in this field by the utility are very real. As mentioned earlier, in a failure the ratepayer pays the costs while in a success its the investor and not the ratepayer who benefits.

Mr. Chairman, while there may well be changes required in the Public Utility Holding Company Act to eliminate many of the regulatory burdens, I don't feel that it is in the public interest to allow and to encourage further utility diversification. Diversification will have a negative effect on competition by allowing the protected position and benefits of the utility monopoly to be utilized in non-utility fields. We urge that as long as utilities enjoy a protected monopoly status that there functions be limited to producing energy.

If utilities are allowed to diversify into heating, solar, hot water, etc., they will force many marginal wholesalers and contractors out of business.

Senator D'AMATO. Thank you, Mr. Stanley.

Mr. Farbman.

Mr. LAVALLEE. My name is Dennis Lavallee. Mr. Farbman is recovering from pneumonia and is not able to be here this morning, so my comments are on his behalf.

He's a well known New York City contractor and he is the Chairman of the Legislative Committee of the National Association of Plumbing, Heating and Cooling Contractors. I am Director of Government Affairs of the NAPHCC.

STATEMENT OF DENNIS LAVALLEE, DIRECTOR OF GOVERNMENT AFFAIRS, NATIONAL ASSOCIATION OF PLUMBING, HEATING & COOLING CONTRACTORS

Mr. LAVALLEE. The National Association of Plumbing, Heating & Cooling Contractors, the NAPHCC, is the oldest national association in the construction industry, and the largest in the plumbing, heating, and cooling industry. It has over 6,400 members all across the country. We are organized in about 300 State and local associations; and the industry employs over 400,000 people, with receipts of over $21 billion.

I am here today to express opposition to the four bills you have before you, because of the adverse impact that they will have on us as small businessmen.

We believe that these bills favor large business utilities over small businesses. Moveover, these are large businesses that are protected and guaranteed a profit. That profit is based on compulsory rates which consumers must pay.

We believe the Public Utility Holding Company Act discourages monopolization and encourages competition.

REVISIONS THREATEN SMALL BUSINESSES

The PUHCA was originally enacted to curtail abuses which may be less likely to recur today. However, it has also grown to fill another purpose which may be more important today: The preservation of the free enterprise small business contractors. Revisions to the Act threaten to promote monopolization and encourage the destruction of contractors in the energy conservation market.

Utilities are frequently large businesses who are guaranteed a profit by the State Public Utility Commissions. Our contractors are small businesses, and they compete vigorously to even make a profit.

With the increased attention being devoted to energy conservation, we have also seen a growth in utility activity in markets that have traditionally been the contractors'. Removing restrictions would encourage diversification into the markets of small business contractors. Utilities would be more free to devise strategies which enhance their strengths and to avoid the oversight of State Public Utility Commissions. Even under existing law, utilities are reaching into our markets.

Utility rate structures provide for guaranteed profits or return on investment. Since the rate of return is set by the public utility commission, the utility must turn to increasing its investment which provides a larger rate base to enable it to increase profits. This, in turn, produces higher rates to the consumer.

The competition created by the utility may result in lower direct costs to the consumer in the short term. However, this hides the indirect costs for the overhead and bureaucracy of the utility paid by all ratepayers. Furthermore, once monopolization occurs, experience indicates that prices go up. This is certainly probable in this instance, because the energy conservation efforts are not regulated.

As recently as the beginning of the last decade, utilities were aggressively promoting energy consumption to enhance revenues and investment. With the onset of the energy crisis in the mid-1970's, utilities sought new means to compensate for declining revenues——

Senator D'AMATO. I notice you have a very comprehensive statement, and I want to assure you that I will ask that the statement be placed in the record, as if read in its entirety. But I must ask whether you could possibly summarize your testimony, since we still have another witness to hear from this morning.

Mr. LAVALLEE. I think we would like to point out—which is in the statement—that the Securities and Exchange Commission, as they have testified this morning, are supporting repeal. But in their December 21 letter to you, Mr. Chairman, Chairman Shad did note that the PUHCA "continues to have significant influence on the financing and diversification decisions of a much larger portion of the industry."

He goes on to say that utilities may be reluctant to form holding companies, because they would then have to register under the Act, to quality for an exemption.

We are also concerned that through the Public Utility Holding Company Act, it may be used to circumvent some of the prohibitions under the National Energy Conservation Policy Act, NECPA, which was referred to a moment ago. There are some prohibitions there. And eliminating the PUHCA would create problems there.

There are some specific areas that I would like to quickly review, where we feel that the utilities particularly jeopardize us:

AREAS OF JEOPARDY

They have marketing, publicity, economic, and technical experts to develop messages to the consumers, which contractors cannot compete with.

They can negotiate favorable prices, through bulk orders.

They have direct mail access to all homes.

They benefit from cross-subsidization by all rate-payers.

And whether through a subsidy or directly, they can make credit checks, so that they know the types of consumers they're dealing with.

They can provide financing, while many of our contractors cannot. We are financing the government, through retainage and other procurement problems, so it's very difficult for us to finance the consumer as well.

We believe that the market disruption is already occurring. And attached to the statement are a number of case studies that we have identified, which indicate where market disruption has already occurred—in energy conservation products, et cetera.

We are concerned that if these efforts continue, that the result will be a lack of alternatives for the consumer to choose from.

Mr. Baxter earlier alluded to what he believes, that in fact the antitrust division can take care of problems. I would like to note that among the cases in the appendix, we discuss a case where there is a $150 rebate provided on gas water heaters by a utility in the Northwest area. I'm not aware that the Justice Department antitrust division is examining this predatory pricing, or any of the other problems of unfair price competition which our contractors have been indicating to us.

Let me just maybe summarize by quoting from the conclusion of the statement, that an analysis of the revisions to the PUCHA should go beyond an evaluation of utility company financing. Such analysis should consider the anticompetitive effects unleashed on small business contractors.

I would like to quote from a statement to the Senate Small Business Committee during SBA budget authorization hearings, on February 23, 1982:

> Small businesses comprise the very backbone of this nation. They are already at a very great disadvantage in the marketplace. We cannot and should not worsen their situation.

We concur wholeheartedly, Mr. Chairman, with your statement to the Small Business Committee. We believe that it also has direct applications here. The act provides protection which must be maintained. Loss of the protection will result in a significant loss to the small businesses and major market disruption. We are at the threshold of those changes. And, rather than promoting the demise of small business contractors, government action is mandatory to reverse the damage that has already been done.

Choices must be maintained for the consumer, or monopolization will produce higher costs to the consumer. Contractors are already facing increased competition in many, many parts of the country, because of the competitive imbalance, such as the cross-subsidization issue, their control of resources, et cetera. We believe that that competition is unfair and anticompetitive.

Such unfair and anticompetitive behavior should be curtailed, not enhanced. Thus, we not only oppose changes, but we recommend that you develop stronger measures to protect small businesses.

Thank you. I will be happy to answer any questions.

[The complete statement follows:]

STATEMENT OF DENNIS LAVALLEE, NATIONAL ASSOCIATION OF PLUMBING, HEATING, COOLING CONTRACTORS

Mr. Chairman, my name is Dennis Lavallee and as Director of Governmental Affairs for the National Association of Plumbing-Heating-Cooling Contractors (NAPHCC), I am here speaking for its Legislative Committee and on behalf of the association.

The National Association of Plumbing-Heating-Cooling Contractors is the oldest national association in the construction industry and the largest in the plumbing-heating-cooling industry. It has over 6400 members. Membership comes from every state in the country and is organized through about 300 state and local affiliated associations. This industry employs over 400,000 people and has receipts of over 21 billion dollars.

I am appearing today to express our opposition to the 3 bills you have before you because of the adverse impact they will have on us as small businessmen. We believe that these bills favor large business utilities over small businesses. Moreover, these are large businesses that are protected and guaranteed a profit. That profit is based on compulsory rates which consumers must pay.

PUHCA DISCOURAGES MONOPOLIZATION AND ENCOURAGES COMPETITION

The PUHCA was originally enacted to curtail abuses which may be less likely to recur today. However, it has also grown to fill another purpose which may be more important today—the preservation of the free enterprise small business contractors. Revisions to the Act threaten to promote monopolization and encourage the destruction of contractors in the energy conservation market.

Utilities are frequently large businesses who are guaranteed a profit by the state public utility commissions. Our contractors are small businesses who compete vigorously to even make a profit.

With the increased attention being devoted to energy conservation, we already have seen a growth in utility activity in markets that have traditionally been the contractor's. Removing restrictions would encourage diversification into the markets of small business contractors. Utilities would be more free to devise strategies which enhance their strengths and to avoid the oversight of state public utility commissions. Even under existing law, utilities are reaching into our markets.

Utility rate structures provide for guaranteed profits or return on investment. Since the rate of return is set by the public utility commission, the utility must turn to increasing its investment which provides a larger rate base to enable it to increase profits. This, in turn, produces higher rates to the consumer.

The competition created by the utility may result in lower direct costs to the consumer in the short term. However, this hides the indirect costs for the overhead and bureaucracy of the utility paid by all rate payers. Furthermore, once monopolization occurs, experience indicates that prices go up. This is certainly probable in this instance because the energy conservation efforts are not regulated.

As recently as the beginning of the last decade, utilities were aggressively promoting energy consumption to enhance revenues and investment. With the onset of the energy crisis in the mid 70's, utilities sought new means to compensate for declining revenues and settled on increased penetration of the energy conservation markets to gain new income. They already had some involvement in service work. These efforts are now extending to sales and installation as well. Some utilities are anxious to establish good reputations which enhance their ability to branch out even further into these areas.

REMOVAL OF RESTRICTIONS WOULD ENCOURAGE CIRCUMVENTION OF OTHER LAWS

Although the Securities and Exchange Commission supported repeal of PUHCA in their December 21, 1981 letter to you, Mr. Chairman, they also noted the effect which the Act has on competition by utilities. It notes that while the act only subjects 12 active holding companies to direct regulation, it "continues to have significant influence on the financing and diversification decisions of a much larger portion of the industry."

Quoting further, Chairman John Shad said "Utilities may be reluctant to form holding companies because they would then have to register under the Act or qualify for an exemption."

The National Energy Conservation Policy Act (NECPA) prohibits utilities from sales, service and installation of energy conservation measures unless they were already involved in these activities prior to enactment. We are already seeing many new initiatives involving the contractors' market by those utilities that were grandfathered. To remove the restrictions of PUHCA would encourage other utilities to escape the prohibition in NECPA through holding company arrangements.

REMOVAL OF RESTRICTIONS WOULD PROMOTE UNFAIR ANTICOMPETITIVE BEHAVIOR

Contractors and their mechanics are highly skilled and technically competent people. Normal requirements for plumbers are 4 years of classroom and on the job apprentice training to become a journeyman and up to 10 years as a journeyman to apply for a master plumbers license and work as a contractor. Two thirds of the states have licensing laws to insure the competency of plumbing contractors. Many of the remaining jurisdictions have local licensing laws.

More than 90 percent of the members of the National Association of Plumbing-Heating-Cooling Contractors are small businesses by standards set by the Small Business Administration. The median contractor nationwide grosses about one million dollars annually and employs a dozen mechanics.

During the last few years, there has been a great deal of public attention to developing public policy that promotes the health and viability of small business. However, even the larger contractors are finding that they are no match to the vast array of resources available to utilities.

Let me cite some examples.

Utilities can hire marketing, publicity, economic and technical experts to develop messages to the consumer. They can target efforts at particular products. The small business contractor cannot afford the overhead to develop these sophisticated marketing tools.

They can negotiate favorable prices through bulk orders directly with manufacturers. A contractor purchases products for installation from his supply house who in turn obtains them from the manufacturers.

Utility companies have direct mail access to the homes of consumers via enclosures with the regular utility bills. Small business contractors must cultivate every lead they get.

Utilities benefit from cross-subsidization by all rate payers, some of it mandated by statute to perform the Residential Conservation Service energy audits under NECPA. Small business contractors must collect all of their costs for a job from that customer. Certainly contractors are in no position to offer rebates as utilities have done.

Whether marketing through a subsidiary or directly, customer credit checks can be made readily by the utility by checking the payment record on utility bills. Such readily available credit checks are not as available to small business contractors.

Utilities frquently have financing programs at favorable interest rates for consumers. The consumer may be able to make payments on energy conservation measures over an extended period of time as part of the utility bills. Small business contractors seldom have the capital or cash flow to provide such financing arrangements.

When utilities or their subsidiaries expand or develop new energy conservation activities, risk plays a different role. If they lose money, they still have the rate base to fall back on. A small business contractor who seeks to expand or develop new markets may find it necessary to risk the whole company with no parent operations to fall back on.

By their very nature as publicly regulated businesses, utilities are monopolies that reach into most homes and businesses in the service area. Signs and markers designate the presence of their facilities and remind us of their network. Every month, we see their bill come in. Every month, we are reminded of the names of the utilities when we write out our checks. Thus, whether they sell, install or service equipment on their own or whether they do so through a subsidiary, they have an immediate advantage of name recognition before they even print their first advertisement.

In contrast, there are usually a number of contractors in an area. Although they compete vigorously, few have the capability to approach the name recognition of the utility because they do not have the same opportunities for comprehensive regular contact with consumers.

If the utility takes over this work, the injury is not only to the small business contractors, but also to the thousands of skilled mechanics they employ, and to consumers who will find they have less alternatives to choose from.

MARKET DISRUPTION HAS ALREADY BEGUN

The threshold for major market penetration has already been crossed. The risk of monopolization of the energy conservation market has probably never been greater. Utility involvement poses threats of major disruption of the market and to the structure of the contracting sector.

Sales of energy conservation products is one major area. Licensing requirements and other state and local regulations assure consumers of the integrity of contracting firms. Yet some utilities are apparently using only selected contractors for installation. The continued use of this practice will institutionalize a market allocation scheme.

If utilities emphasize the sale of equipment, leaving the installation to contractors, then the contracting industry loses its independent and competitive character and becomes beholden to them for business. The utility enters the ranks of brokers of contracts. If the utilities pursue the installations as well, then many small business contractors will be left bankrupt in the trail of growing utility dominance.

Utilities have already made major inroads in the sale, installation and service of equipment which have traditionally belonged to the contractor. As an appendix to my testimony, I have attached a number of examples of these intrusions into our markets.

In a recent survey of our membership, 45 percent see sales and installation of gas fired appliances by utility companies. In addition, more than half of the contractors agree that utilities offer an unfair price advantage.

While we would hope that the state public service and public utility commissions would stem the tide of the utility growth, that has generally not been the case. As in Florida and in New York, the commissions have focused on energy conservation and have not been concerned with looking at the competitive impact, particularly on small business.

As a result, the small business contractors who struggle to even make a profit are being forced to support their competitors, the large utilities who are guaranteed a profit. Support comes in the taxes contractors pay which support Department of Energy programs institutionalizing unfair competition. However, even more direct support is provided by the utility rate which contractors must pay which include cross-subsidization.

CONCLUSION

Any analysis of revisions to PUHCA should go beyond an evaluation of utility company financing. Such analysis should consider the anticompetitive effects unleashed on small business contractors.

The Act provides protection which must be maintained. Loss of that protection will result in a significant loss of small businesses and major market disruption. We are at the threshold of those changes. Rather than promoting the demise of small business contractors, government action is mandatory to reverse the damage that has already been done.

Contractors are already facing increased utility competition in many parts of the country. Because of the competitive imbalance, such as cross subsidization, their control of resources, etc., we believe that that competition is unfair and anti-competitive. Such unfair and anti-competitive behavior should be curtailed, not enhanced. Thus, we not only oppose changes that weaken the PUHCA, but we ask that you develop stronger measures to protect small business.

Thank you, and I would be happy to answer any questions.

ATTACHMENT

CASES OF UNFAIR UTILITY COMPETITION

Public Service Electric & Gas (PSE and G)

In New Jersey, the Public Service Electric and Gas Company is proceeding with plans to provide solar hot water systems to consumers. The program has been approved by the New Jersey Board of Public Utilities and the state Energy Commissioner under rules developed in accordance with the Energy Security Act of 1980.

Under this program, the systems will be made available to residential customers as a supplementary source for hot water. The major system components will be supplied by PSE and G and the installations will be made by contractors.

Beyond the loss of the opportunity to sell these systems, there are other disturbing features. First, a select group of only a handful of highly screened contractors who have demonstrated an ability to perform quality work at a reasonable price and in a business like manner will be used for the installations. What seems to be forgotten is that New Jersey has a statewide licensing law for contractors which assures consumers that any licensed contractor fits these criteria. Yet, under the authority of federal law, a regulated public utility is allocating this market under some presumed higher level of standards.

Secondly, the utility has argued that it must be able to carefully select the customers for participation in the program. For example, households must be less than five persons, have a roof in good condition and have a roof which faces in a southerly direction. They point out that they want to prove the success of solar to New Jersey homeowners. Certainly, these characteristics are reasonable to expect in a solar installation. Consumers may apply to have a system installed. However, it is the utility and not the consumer that is making the final decision whether the system will be sold and installed. The result is that the utility is selecting the cream of the crop, leaving potentially less successful systems for other contractors to go after. These run the risk of costing more or of producing less results because of the necessity of overcoming the handicaps which caused the utility to reject them. When energy conservation results are announced, PSE and G hopes to bask in the glory of a good reputation for its efforts at a reasonable cost. Meanwhile, other contractors may be saddled with explaining why their projects were less successful.

Thirdly, the utility has offered a financing program to the consumer to assist in paying for the system. The larger financial resources of the utility give it a key marketing advantage not available to the typical plumbing-heating-cooling contractor.

Long Island Light Co. (LILCO)

Last year Long Island Light Company (LILCO) conducted a similar program installing 600 solar systems.

A trade publication for the industry, Contractor magazine, best summarized the impact of this when they editorialized September 1, 1981.

"Even by signing contractors to install these systems, the utilities are playing their long-standing game of retail domination. Plumbing contractors who value their independent expertise stand to lose another strong base for a natural and potentially great business opportunity.

"It's that old story all over again, where captive contractors are rounded up for their mechanical skills and especially their licensed plumbing code connection. But these contractors get the crumbs of the labor-only part of the job, being eliminated from the sale of the equipment by the subsidized utility program with its high-powered advertising campaign."

LILCO now has a proposal pending before the New York Public Service Commission to allow it to operate an independent subsidiary corporation named LILCO Energy Systems, Inc. The purpose of the new company is to sell energy conservation devices, solar energy systems, gas furnaces and heat pumps to Long Island consumers. LILCO is seeking to lend the subsidiary 1 million dollars.

The similarity in names will make any differentiation between the two companies indistinguishable to the consumer. Furthermore, if LILCO Energy Systems loses money in its operation, who will make up that loss? Any losses passed on to the parent LILCO will produce a loss in operating funds which the company will seek to recapture through adjustments in the rate base.

Thus, contractors face the threat of a large new company in the marketplace which benefits from name recognition and little fear of losses. Unfortunately, the Public Service Commission has prohibited testimony concerning the competitive impact of the LILCO subsidiary. The state Attorney General's office has formally objected to that exclusion.

Florida Power & Light

Last fall, Florida Power and Light (FPL) announced it was seeking bids from major manufacturers for 8,000 water heater insulation kits. Our Florida association reported to the Governor's Energy Office,

"The 10 largest plumbing/mechanical contractors in the state don't buy this item in such quantities. This is the primary reason why FPL claims its installation cost will be approximately $20, roughly half of a contractor's installed price. Contractors buy from suppliers, which puts a middleman in the economic scheme of things. Do the suppliers of Florida know that this giant corporate utility, protected by monopolistic statutes with a guaranteed profit, is going to be buying directly from the manufacturer?

"The heavy advertising campaign planned by FPL will doubtless bring a great deal of awareness to the availability of these blankets. It is doubtful that Mr. and Mrs. South Florida, when they inquire as to price, will contact their neighborhood plumber. The contractors can't buy the blankets at FPL cost, plus he has an overhead cost such as truck insurance, worker's compensation, labor, etc.

"The contractor is traditionally paid at the conclusion of the job. FPL plans to add its cost to the customer's monthly statement. This convenient pay-as-you-go plan would be an unfair advantage."

A member of the Florida Public Service Commission acknowledged that all he wanted to do was conserve energy and that he was not bothered by unfair competitive practices.

Connecticut Natural Gas Corp.

The Connecticut Natural Gas Corporation operates a fleet for servicing residential equipment and has acknowledged to the Public Service Commission that they receive about 1 percent in profit from these operations. Questions have been raised whether the contracting operations reflect the costs of overhead which contractors must cover or whether some of the costs are being included in the rate base. Thus service work would be cross-subsidized by all rate payers. The Public Service Commission has ordered the utility to keep separate books for the contracting operations, but those have yet to be forthcoming.

In addition, there are charges that only "select" contractors get contracts from the utility.

Lone Star Gas

Lone Star Gas has appealed to the Waco, Texas, City Council for exclusive ownership of supply lines. The local contractor association has charged that this would allow the utility to become "more monopolistic than they already are." One contracting firm has estimated that the proposal would cost him $75,000 a year in business and require the release of two employees.

Similar proposals are scheduled for consideration by the town councils of Temple and Hewitt, Texas and the Lone Star proposal in Robinson was voted down.

Piedmont Natural Gas

Action has been filed before the North Carolina Public Utility Commission charging Piedmont Natural Gas with subsidizing its operations for the supply and installation of gas water heaters.

Piedmont is alleged to be including costs from these operations in the rate base which is paid by all rate payers. Contractors are losing business to the utility through this unfair cross subsidization.

Wisconsin Power & Light Co.

The Wisconsin Power and Light Company (WPL) has been selling solar water heater units at $1.00 over costs. Our local contractor association advises us that the units were being sold and installed for less than what the contractor can get the units for from the wholesaler.

In addition, the company has initiated service maintainance contracts for furnaces for $59.95. They sell water heaters and other energy conservation devices and they provide low interest financing.

Recently, WPL and other Wisconsin utilities have sought to establish holding companies. Under this arrangement, the parent company would oversee the utility business, which is regulated and promote other operations through the unregulated business.

Northwest Natural Gas

When Northwest Natural Gas begen selling and installing gas water heaters and providing a $150 rebate, contractors saw their sales plummet. The gas company hired its own service people to do the installations so that even contractors on the company's list saw their share of installations drop to zero. When the utility was in the business of replacing thermocouplings a few years ago, contractors share of the market dropped to 10 percent. The utilities charged $10 for the combination of materials and one half hour of labor while estimating that replacement actually cost them $34.00.

For installations assigned to contractors under current programs, the utility uses a referral list. However, the gas company is selective and contracts with some contractors and not with others. In addition, a suit initiated by a contractor association alleges that work is not necessarily provided to contractors, but rather is assigned to moonlighting repairmen.

Obviously, a utility company which reaches into the homes of all gas consumers is in a very strong market position. They get a large number of calls and are in a key position to refer work. As a public utility, they should have an obligation to deal with bona fide contractors in a fair and equitable manner.

CASES OF FAIR COMPETITION

Equitable Gas Co., Columbia Gas Co., and People's Natural Gas Co.

The Pennsylvania Public Utility Commission is currently considering a proposal to transfer the responsibility for maintaining residential gas service lines in Pittsburgh, PA from the consumer to the utility companies. Thus, work normally performed by plumbing-heating-cooling contractors in the area would be transferred to the local gas companies. Fortunately, even the utilities in the Pittsburgh area, Equtable Gas Company, Columbia Gas Company, People's Natural Gas Company are opposing this proposal.

Equitable Gas has pointed out their objections:

(1) The proposal is discriminatory against low income people who generally have short service lines and it will require subsidizing the wealthy who have larger lots and longer service lines.

(2) Those who have recently had new lines installed as their own expenses will be paying additional fees for others.

(3) Utilities are less cost-efficient, both from a labor standpoint due to work rules, and from a liability standpoint.

(4) From economics, utilities would need to borrow money to subsidize installations. Both the interest charges and the higher operating costs would be passed on to consumers in the rate base.

Minnegasco

The Minnesota Public Utilities Commission (PUC) has ruled that Minnegasco's program of servicing and installing customer appliances is a non-utility function. The PUC concluded that all gas customers should not be required to shoulder costs from Minnegasco's service and installation operations and costs associated with it should not be included in the rate base.

As a result of the decision, Minnegasco has included all of its costs, such as overhead in developing its schedule of service rates. Customers will now pay for normal service at the rate of $29.95 for the first half hour and $42 for each additional hour. Special services and service contractors are also priced to incorporate all costs of providing the services.

Contractors in Minnesota have hailed the decision as a victory and they expect to compete much more successfully.

Senator D'AMATO. Thank you.

Let me ask you this. In his testimony, Mr. Baxter suggested that the act does not prevent utilities from going into your business. And, as you stated, he believes that the antitrust laws were sufficient to deal with any problems that could arise in this area.

Could you indicate which provisions of the act you feel are barriers to diversification into the activities which you have described?

Mr. LAVALLEE. We are not utility experts. Our areas tends to be much more in the specific construction area.

But I place a great deal of credence in the quote that I quoted from Chairman Shad's statement; that even he believes that the PUHCA would tend to restrict diversification not just of the 12 companies, but of those companies that are not regulated. I think that's a significant statement right there, that presents a strong argument why the act ought to remain in place.

Senator D'AMATO. That's one of the considerations which the subcommittee will have to take into account, whether the act itself really does provide you with the protection you seek. Because possibly what needs to be done to deal with this problem, if it's possible, is an amendment to the National Energy Conservation Policy Act, to strengthen and expand the prohibition of utilities' entering these markets.

That might be the appropriate vehicle, rather than the retention of the Public Utility Holding Act, which I suspect has not done nearly what you think it does.

Let me say that both you and Mr. Stanley have added another dimension to our review of the Holding Company Act. Obviously, your point is that you don't want to see the difficulties you have outlined become even greater. And maybe the Public Utility Holding Act is indeed affording your industry some protection.

I will ask the staff and the agencies that I have mentioned to give us a reply to your submission.

We thank you for your testimony and for giving us that other point of view, which is so important.

Senator Schmitt.

Senator SCHMITT. Mr. Chairman, we have with us today a young man, Tom Lewis, a good friend of mine, one with whom I've walked blocks with, politically, in New Mexico, who is now a State senator in District 15 in the great State of New Mexico; who has spent an extraordinary amount of his own time and resources researching this general problem of public utilities and public utility diversification.

We have a strong public utility, a major one, in New Mexico, the Public Service Company of New Mexico. It has been reaching out in an intrastate manner to diversify, the argument being that this strengthens the overall economic base of a utility in the eyes of potential stockholders, as well as in the eyes of the bond market.

On the other hand, there is a concern in our State, as in many States, that the use of funds derived from ratepayers to diversity not only may put at risk those funds, but also may cause unfair competition with local businesses involved in the same types of activities as are undertaken through diversification by the utility.

I think that you will find that Mr. Lewis' comments are perceptive on this issue. I know of no one in the State of New Mexico, and possibly no one in his legislative position in any State, that has taken the level of interest that he has in this issue, and has researched it to the depth that he has.

And I'm looking forward to his remarks, and looking forward to continuing to work with him, as well as you, Mr. Chairman, on this very important issue.

Senator D'AMATO. Mr. Lewis.

STATEMENT OF TOM LEWIS, STATE SENATOR, ALBUQUERQUE, N. MEX.

Mr. LEWIS. Thank you, Mr. Chairman, Senator Schmitt. I appreciate the opportunity to appear before you today.

As has been pointed out, my name is Tom Lewis. I'm a State senator from New Mexico. I earned a bachelor of arts degree and a master's in business administration at Cornell University. So, I'm somewhat familiar with your territory, Mr. Chairman.

Senator SCHMITT. We don't even hold that against you. [Laughter.]

Mr. LEWIS. Until late 1980, I owned and managed the largest commercial printing and publishing firm in New Mexico. I mention these only to demonstrate that I have a strong background in both the theory and the practice of business. I'm a strong advocate of free enterprise. I've gone to the trouble and expense to be here today, because I believe you may determine the outcome of one of the most important domestic economic issues we will face in this decade, and that is utility diversification. I would point out that I am here at my own expense, and I have absolutely nothing to gain financially from the outcome of this issue, except, I suppose, as a ratepayer. We all have that.

Some public utilities argue that by expanding into nonutility businesses, they will reduce the risk for their stockholders and enhance their stockholders' return on investment. As a result, they argue, their cost of capital will be reduced, and they will need fewer and smaller rate increases. I contend that it is not in the public interest to allow utilities to engage in businesses unrelated to the utility business. I strongly oppose any measures, such as those you are considering, which would facilitate or encourage diversification by public utilities into nonutility businesses. My reasons are many and they include the following:

IMPACT OF UTILITY DIVERSIFICATION

First, there will be no material benefit to the ratepayer. Profits, presumably, would not be credited toward utility revenues. Significant losses, or even the threat of losses, could harm the utility's credit rate and increase its cost of capital, thereby contributing to higher rates.

Healthy utilities with good credit already enjoy the lowest cost of capital in the country and will have great difficulty reducing their cost of capital through diversification. The weak and less glamorous utilities will also have difficulty reducing their cost of capital through diversification because: (a) Diversification will strain their cash flow and cause it to be more unreliable, (b) they often suffer from fundamental problems, which is noncompensatory rates, that diversification can't solve and, (c) rate increases may be deferred due to the extra effort required by regulators to examine a diversified enterprise. Good regulatory policies, combined with good management, will do far more for the long-term health of the industry.

It is illogical, if not downright absurd, to think that financial weak utilities that need to invest heavily in new plant will enhance their ability to raise capital for utility investment by diversifying. Diversified activities are unlikely to affect the performance of a utility's stock, unless they represent a substantial part of the utility's holdings, and weak utilities can't afford the heavy initial investment required for substantial nonutility ventures.

Furthermore, if the new ventures are as promising as the utilities would suggest, prospective buyers of newly issued stock will want to have their capital contributions invested in the new ventures—not in ailing utility operations.

There is a very real danger that a disproportionate amount of management effort and attention will be directed toward the nonutility ventures and that the utility business will, as a result, become less efficient, causing rates to rise. This is particularly likely to occur when management incentives encourage it. Last year, for example, the president of Public Service Company of New Mexico, whom we know as PNM, received 35 percent of his compensation from nonutility operations which comprise less than 6 percent of the company's assets. In fact, there is evidence that the distraction of nonutility activities is already taking a high toll at PNM. Last year PNM embarked on a major expansion of its nonutility businesses. Since then, its operating expenses have soared in relation to power sales. In the second quarter of 1981, for example, PNM's operating expenses increased 19.4 percent, while kilowatt hours sold rose 9.6 percent compared to the same quarter 1 year earlier, implying a 10-percent rate of inflation. In contrast, if we compare PNM's performance during the first quarter of this year to that of last year, we find that PNM's operating expenses increased more than 45 percent, while kilowatt hours sold rose only 3.6 percent. This means that PNM has allowed its unit operating costs to increase four times faster than before during a period when inflation has generally declined.

I would add that they are largely coal-fired, and they're reaching the end of a heavy construction program. So, this performance really sort of puzzles me.

Generally speaking, utility managers have little experience in competitive markets and nonutility businesses. This increases the probability that these businesses will fail or survive only as marginal operations that will devour capital and management attention.

Costs that should be charged to nonutility customers might be charged to utility operations, thereby contributing to higher rates. In fact, many regulators don't know at this point what the proper allocation of costs should be. It is far more difficult to prevent misallocation of costs in practice than it is in theory. If the utility business were highly cyclical, diversification into business with different business cycles might help to stabilize the utility's cash flow and reduce its risk, but utilities are not particularly cyclical, and the regulatory process is generally designed to minimize earnings volatility and risk. Because a diversified utility is likely to have more volatile earnings, it is liable to have difficulty maintaining a high bond rating, unless it increases its coverage ratio—hardly a benefit to the ratepayer.

It is quite possible that after using the utility's capital base to fund new ventures, the parent company will spin off the utility, leaving it independent and undiversified again. This has happened in the case of Louisiana Electric. It appears about to happen in New Mexico, where Southern Union Co. wants to divest Gas Company of New Mexico. In such cases, a utility and its ratepayers would suffer most of the disadvantages and reap few of the benefits of diversification.

Diversification is not likely to enhance the stock prices of utilities over the long term. Research indicates that in times like these, many investors prefer higher, relatively certain dividends to uncertain long-term capital gains. As stock market analysts have pointed out, an investor would probably be better advised to invest separately in a nondiversified utility and in other nonrelated companies in other industries than to invest in a diversified utility.

I'm sure you've heard from stockbrokers and investment bankers who support this legislation. I would point out that these people make many millions in commissions and underwriter fees each year from the utility companies. And this legislation would probably benefit them. Brokers and bankers who support my position have warned me not to expect much public support from their industry. Moreover, brokers are hardly infallible. The same firm that has testified in other hearings in support of this legislation was urging its clients to buy bonds last year only a couple of months before the bottom fell out of the bond market.

Having reviewed some of the effects of diversification on utility management and finance, let's discuss a very important concern, that is, its impact on regulation.

Senator D'AMATO. Senator, I wonder if you would summarize the balance of your remarks, so that we could then have an opportunity to ask you some questions. Of course, your entire statement will be received into the record as if read in its entirety.

Mr. LEWIS. Fine, Mr. Chairman. I'll be happy to do that.

REGULATORY PROBLEMS

I make the point that diversification will complicate the regulatory process, requiring additional funding and staff for regulator commissions. I think it will not live up to its claims. I think that it poses a very real threat to free and fair competition in the private sector. Many of my arguments were mentioned by the people who preceded me.

I would emphasize that it's been suggested that business people are opposed to utility diversification and are merely afraid of competition. That's nonsense. Most of the people who I've talked to who are concerned about it are from highly competitive industries, who are very accustomed to meeting competition. They are merely concerned about having to compete on equal terms. This is not a situation where a company has gotten big because it has done something particularly brilliant or has an unusual degree of efficiency. Utilities are large, generally, simply because they've been granted a monopoly franchise for an almost indispensable product in a large territory.

I think that the main problems of utilities lie in the area of better regulation. There are some commissions that have been overly harsh with their utilities and tried to keep rates at an unreasonably low level. The utility industry has been battered by inflation and high interest rates, and I think there's nothing you people in Congress can do that will help them more than to arrive at a budget package and an economic policy that will contribute to the moderation of inflation and interest rates.

I think they're selling you a bill of goods. I would point out that several people have suggested that the act really isn't affecting utility diversification that much in the first place.

I'll respond to that in a couple of ways. First of all, I think it's very symbolic. And I'm very concerned that repeal of the act will be perceived by the public, by the legislatures around the country as being a sanctioning of diversification. I don't think that's really your intent. I think to some degree you think that would make sense, but I would like to think that some of the proponents of this legislation have not considered up to now all the ramifications involved.

I would point out that there's a reason why so few companies are affected. It's because the act has been effective in preventing or discouraging the formation of utility holding companies. Imagine a farmer surveying his holdings and finding that he's got a heifer in one pasture with a secure fence around it, next to a vigorous bull, and he notes that she hasn't calved. Now do you suppose that if he didn't want her to calve for some reason, that he would go open the gate to the bull? And that's what we're talking about doing here.

There is a reason that so few companies are affected directly. And I know for a fact that New Mexico utilities have deliberately not gone in to an interstate operation or any other mode of operation under the act, because they don't want to be subject and because it would restrict them.

I do not think the antitrust laws can deal effectively with the problems of unfair competition that we've discussed, particularly in the case of smaller firms. They'll be out of business before a decision is ever reached, and I would encourage you not to put too much stock in that.

Finally, I'd like to point out that I think the political consequences of repeal of this measure should not be underestimated. I think utility diversification will result in a strong negative reaction which will have influence on the regulation process, and so on, and probably hurt utilities more than diversification will ever help. I would point out that right now the public is not aware of these proposals, from what I can tell, but I assure you that they will become aware at some point, and they will view it, I think, about as favorably as they viewed some of the tax breaks which you're now trying to rescind. I'm talking about the tax breaks for congressmen.

I would point out that switchboard operators at the New Mexico Legislature who had worked there for years told me that they had never received so many calls on a single issue, as they did on legislation in our Legislature that would limit utility diversification.

Thank you, Mr. Chairman. I'll be happy to answer any questions.

[Complete statement follows:]

STATEMENT OF THOMAS E. LEWIS, STATE SENATOR, DISTRICT 15, NEW MEXICO

Thank you for the opportunity to speak to you today. My name is Tom Lewis, and I am a state senator from Albuquerque, New Mexico. I earned a Bachelor of Arts degree and a Master's in Business Administration from Cornell University, and until late 1980 I owned and managed the largest commercial printing and publishing firm in New Mexico. Thus I have a strong background in both the theory and practice of business. I am a strong advocate of free enterprise.

I have gone to the trouble and expense to be here today because I believe you may determine the outcome of one of the most important domestic economic issues we will face this decade: utility diversification.

Some public utilities argue that by expanding into non-utility businesses they will reduce the risk for their stockholders and enhance their stockholders' return on investment. As a result, they argue, their cost of capital will be reduced, and they will need fewer and smaller rate increases.

I contend that it is not in the public interest to allow utilities to engage in businesses unrelated to the utility business. I strongly oppose any measures, such as those you are considering, which would facilitate or encourage diversification by public utilities into non-utility businesses. My reasons are many, and they include the following:

First, there will be no material benefit to the ratepayer. Profits, presumably, would not be credited toward utility revenues. Significant losses, or even the threat of losses, could harm the utility's credit rating and increase its cost of capital, thereby contributing to higher rates.

Healthy utilities with good credit already enjoy about the lowest cost of capital in the country and will have great difficulty reducing their cost of capital through diversification. The weak and less glamorous utilities will also have difficulty reducing their cost of capital through diversification because (a) diversification will strain their cash flow and cause it to be more unreliable, (b) they often suffer from fundamental problems (e.g. non-compensatory rates) that diversification can't solve, and (c) rate increases may be deferred due to the extra effort required by regulators to examine a diversified enterprise. Good regulatory policies combined with good management will do far more for the long term health of the industry.

It is illogical, if not downright absurd, to think that financially weak utilities that need to invest heavily in new plant will enhance their ability to raise capital for utility investment by diversifying. Diversified activities are unlikely to affect the performance of a utility's stock unless they represent a substantial part of the utility's holdings, and weak utilities can't afford the heavy initial investment required for substantial non-utility ventures. If the new ventures are as promising as the utilities would suggest, prospective buyers of newly issued stock will want to have their capital contributions invested in the new ventures—not in ailing utility operations.

There is a very real danger that a disproportionate amount of management effort and attention will be directed toard the non-utility ventures and that the utility business will, as a result, become less efficient, causing rates to rise. This is particularly likely to occur when management incentives encourage it. Last year, for example, the president of Public Service Co. of New Mexico (PNM) received 35 percent of his compensation from non-utility operations which comprise less than six percent of the company's assets.

In fact, there is evidence that the distraction of non-utility activities is already taking a high toll at PNM. Last year PNM embarked on a major expansion of its non-utility businesses. Since then, its operating expenses have soared in relation to power sales. In the second quarter of 1981, for example, PNM's operating expenses increased 19.4 percent while KWH sold rose 9.6 percent compared to the same quarter one year earlier—implying a ten percent rate of inflation. In contrast, if we compare PNM's performance during the first quarter of this year to that of last year, we find that PNM's operating expenses increased more than 45 percent while KWH sold rose only 3.6 percent. This means that PNM has allowed its unit operating costs to increase four times faster than before—while inflation generally declined.

Generally speaking, utility managers have little experience in competitive markets and non-utility businesses. This increases the probability that these businesses will fail or survive only as marginal operations that will devour capital and management attention.

Costs that should be charged to non-utility customers might be charged to utility operations, thereby contributing to higher rates. In fact, many regulators don't know at this point what the proper allocations of costs should be. It is far more difficult to prevent misallocation of costs in practice than it is in theory.

If the utility business were highly cyclical, diversification into businesses with different business cycles might help to stabilize a utility's cash flow and reduce its risk. But utilities are not particularly cyclical, and the regulatory process is generally designed to minimize earnings volatility and risk. Because a diversified utility is likely to have more volatile earnings, it is liable to have difficulty maintaining a high bond rating unless it increases its coverage ratio—hardly a benefit to the ratepayer.

It is quite possible that after using the utility's capital base to fund new ventures, the parent company will spin off the utility, leaving it independent and undiversified again. This has happened in the case of Louisiana Electric. It appears about to happen in New Mexico, where Southern Union Company wants to divest Gas Company of New Mexico. In such cases, a utility and its ratepayers would suffer most of the disadvantages and reap few of the benefits of diversification.

Diversification is not likely to enhance the stock prices of utilities over the long term. Research indicates that in times like these many investors prefer higher, relatively certain dividends to uncetain long term capital gains. As stock market analysts have pointed out, an investor would probably be better advised to invest separately in a non-diversified utility and other unrelated companies in other industries than to invest in a diversified utility.

I'm sure you've heard from stockbrokers and investment bankers who support this legislation. I would point out that these people make many millions in commissions and underwriting fees each year from the utility companies, and this legislation would probably benefit them. Brokers and bankers who support my position have warned me not to expect much public support form their industry. Moreover, brokers are hardly infallible. The same firm that has testified in other hearings in support of this legislation was urging its clients to buy bonds last year only a couple of months before the bottom fell out of the bond market.

Having reviewed some of the effects of diversification on utility management and finance, let's discuss a very important concern: its impact on regulation. Diversification will greatly complicate the regulatory process at great expense to the public. Regulatory bodies do not have the expertise to evaluate adequately the potential risks and rewards of non-utility ventures or to evaluate their performance. It will take an army of accountants to see that ratepayers are not subsidizing non-utility ventures, and these must be paid for by the ratepayers or taxpayers. Regulators would be subjected to even more pressure than they are now, as various special interests seek their pet projects.

If utilities are allowed to expand into non-utility endeavors, the public will demand regulatory oversight of these endeavors, resulting in another case of bureaucratic expansion. I urge you to resist the temptation to expand the regulatory empire. The wisest solution is to prohibit utilities from engaging in non-utility ventures so that regulators can do a better job of regulating the operations already subject to their jurisdiction.

Diversification won't live up to its advocates' claims, and it is liable to hurt ratepayers. An even grater concern, however, is that utility diversification poses a very real threat to free and fair competition in the private sector. It will help to weaken the public's faith in the integrity of the regulatory process and in the free enterprise system as well.

In most cases utilities have an unfair advantage over their competitors in non-utility businesses because regulatory policies (which are specifically designed to minimize utilities' cost of capital) allow them to borrow money for several percentage points less than their competitors. Moreover, with a reasonably predictable rate of return, a utility can borrow a far larger amount relative to its equity investment than most other companies.

Real estate developers in particular think it is unfair for a monopoly which is assured a reasonable rate of return in bad times to be permitted to buy real estate for investment at bargain prices, with cheap financing, when seasoned veterans in the business can't afford it.

Because utility managers have little expertise in non-utility businesses, and because they are already assured of a reasonable profit in their utility business, they will be more willing than others to pay a premium for real estate and other assets they acquire. Consequently, they are likely to contribute to inflation and to cause the costs of other businesses to rise unnecessarily.

Business people facing competition from diversified utilities worry that utilities will charge lower than market rates for their non-utility products and services. They think this is likely to happen because a) utilities' costs will not be properly allocated; b) utility-related enterprises will enjoy a lower cost of capital than others; c) utility managers will feel less pressure than others to earn a profit; and d) suppliers will give better treatment and lower prices to a utility-owned enterprise than to a similar enterprise that is not owned by a utility.

Some people have suggested that business people opposed to diversification are merely afraid of competition. That's utter nonsense! Most of them are accustomed to stiff competition and have been successful in meeting it. They just don't want to be faced with competition that enjoys unique advantages that result from government interference in the marketplace.

It is one thing for a big firm like Safeway or Kroger to drive the independent corner grocer out of business and quite another for a large utility-financed venture to drive a heavy contractor or well driller or aircraft charter outfit out of business. Companies like Safeway become large because they offer a better combination of product, price, and service than the corner grocer. A typical utility, on the other hand, has become large not because it has done anything particularly brilliant or innovative and survived competition, but because it was granted a monopoly franchise for an almost indispensable product or service in a large territory.

I would particularly discourage allowing utilities to provide alternate forms of energy or to engage in the heating and air conditioning business—areas in which they have significant marketing advantages. Because they are providing government-required energy audits and have direct access to billing records and other valuable market information, utility-related firms would be in an unusually good position to identify prospects for their products and services, and to promote those products and services. This would be unfair to non-utility competitors. Moreover, if an electric utility, for example, is not allowed to provide solar energy devices or natural gas to its customers, it will have maximum incentive to control its costs and prices in order to compete with the other forms of energy.

Rarely mentioned is the abuse of economic power that can result from diversification—particularly in the mountain West where utilities play a far more dominant role in the economy. I wish you could have heard, as I have, from the many New Mexico businessmen who oppose diversification but were reluctant to testify publicly because they fear economic reprisal from a monopoly. This group includes suppliers, bankers, and contractors who need the utilities' cooperation to get utilities provided to their projects on time.

I am sure that the general public never intended that regulatory bodies allow utilities to acquire even greater economic power through diversification. In fact, the adverse reaction from the public is likely to cause utilities far more problems than diversification can possibly solve. It was not just a coincidence that the New Mexico legislature voted unanimously to outlaw Cost-of-Service Indexing after Public Service Company of New Mexico embarked on a wild diversification spree.

Rather than allow utilities to diversify, regulators should see that well-managed utilities receive an adequate return on investment compared to other investments of similar risk. Much of the interest in diversification has been spawned by regulators who have kept returns at an unreasonably low level. And, as analysts for Salomon Brothers Inc. have noted, many utilities would be better advised to use their earnings to reduce their debt-equity ratios than to invest them in non-utility ventures.

Returns allowed utilities have risen markedly during the last couple of years. In many cases the increases are justified. If we are going to allow higher returns, however, we should pay more attention to productivity and management efficiency. Why should a well-managed utility earn no greater rate of return than a less efficient utility? This has happened in New Mexico. You need to offer more rewards for good management that benefits the consumer.

Because they are so capital-intensive, utilities have taken a tremendous beating from high inflation and interest rates. Nothing would help the utilities more than for you in the Congress to agree on a budget and an economic policy that will cause interest rates to fall without re-inflating our economy.

In a number of instances, the problems faced by utilities have been compounded by bad management. Diversification will not solve problems resulting from bad management.

In conclusion, I would argue that diversification is neither necessary nor desirable from the point of view of either ratepayers or stockholders. It is most likely to benefit those utility managers who want to preside over larger empires and draw larger salaries.

Diversification is not in the public interest because it will result in unfair competition for other private firms and it will contribute to an increase in the amount of economic power wielded by monopolies. Diversification is liable to cause a strong negative reaction from the public which will hurt utilities. What the utilities really need is not to diversify, but a combination of low inflation, lower interest rates, and fair and reasonable regulation which rewards good management.

A FOOTNOTE ON THE POLITICS OF THIS ISSUE

Public utilities and their lobbyists are very aware of what you're doing here. The general public is not—yet. They're preoccupied with the problems of our economy and the Falklands War, etc.

I predict, however, that if you pass this legislation, the general public will soon become aware of it and will be at least as outraged as they were over the special tax breaks for congressmen you're now trying to rescind.

As an example, I would point out that switchboard operators who have worked for the New Mexico legislature for many years told me that they had never before received so many calls on a single issue as they did on Senate Bill 74 to limit utility diversification.

Senator D'AMATO. Thank you very much, Senator. I certainly want to thank you for coming all the way from New Mexico, and not only that, but doing it at your own expense, not on even what we call legislative business that could very well have permitted you to travel at public expense.

Mr. LEWIS. That is not the practice in New Mexico.

Senator SCHMITT. We respect our legislators as business people, not as legislators.

MORATORIUM ON DIVERSIFICATION

Senator D'AMATO. I am wondering if you might comment on the fact that New Mexico recently passed a law imposing a 15-month moratorium on diversification.

Mr. LEWIS. That is correct, Mr. Chairman.

Senator D'AMATO. Is that because you found, as you have outlined, that the utility was in a position to provide the kind of competition that was monopolistic, and consequently small business could not compete equally?

Mr. LEWIS. There were a number of instances that occurred, Mr. Chairman, where the utility had started providing goods or services that were far removed from the utility business and which had raised the question. They have large landholdings in New Mexico. They are engaged in farming and ranching. They are one of the largest owners of water rights in the State. They claim that all these holdings are needed for future power supply.

However, considering they are exporting much of the power they produce now, some people wonder how they could possibly use all the land and water they require for power supply. We would have allowed them to hold such properties provided they could demonstrate that they would be needed for future demand.

The interim committee to study the issue has just been formed. We have not held our first meeting.

Senator D'AMATO. As I understand it, the Public Service Company of New Mexico is not regulated under the Holding Company Act?

Mr. LEWIS. That is right, Mr. Chairman. It operates entirely within the State.

Senator D'AMATO. Therefore, the problems you raise already exist in certain parts of the utility industry, even with the act in place; isn't that correct?

Mr. LEWIS. I grant that, Mr. Chairman, but I would point out that when the act was enacted it seems to me that almost all the utilities that were operating, or a very large number of them, the ones that were causing the problems, were operating in an interstate mode. Many of them have divested themselves of various entities to comply with the act, as I understand.

What I am saying is it has only recently become a problem in New Mexico. It is not as if we are allowing it. We never anticipated the problem, to be honest.

Senator D'AMATO. That is why you took the legislative initiative that you did?

Mr. LEWIS. That is right.

Senator D'AMATO. Let me ask you this: Would you consider recommending Federal legislation to restrict or prohibit diversification of public utilities?

Mr. LEWIS. Yes, I would, Mr. Chairman. I agree that this act is very cumbersome and complicated, and I would have no objection to streamlining it or going some other route, as you suggested earlier, to accomplish the same goal.

My main concern, I am a Republican, I have been an ardent advocate of various deregulation measures, and I have no problem with reducing the regulatory burden on the industry, so long as we don't allow them to abuse the public. And if there is a way to streamline this, that is fine with me.

Senator D'AMATO. Very good. Senator Schmitt.

Senator SCHMITT. Thank you, Mr. Chairman. Tom, do you believe that the repeal of the Public Utilities Holding Company Act would result in a concentration of economic power on the part of a profitable utility?

Mr. LEWIS. Very definitely. In the case of PNM, for example, I would be not at all surprised if they became an interstate operation. They have been very aggressive in acquisitions recently, and I think that it would remove one more barrier to their activity. I think that some of these people are trying to grow for the sake of it, and in a competitive industry I think that is fine. But here we are talking about monopolies, and that is a fundamental difference.

And, I feel that if you want to operate as a monopoly, you get certain benefits granted by the State, so to speak, and you give up certain opportunities in exchange for them. And I do believe it would lead to a concentration of economic power, and that is why I am here.

Senator SCHMITT. What is your analysis of modern trends in rate decisions within New Mexico? Have they generally, in fact, provided a reasonable rate of return for PNM?

Mr. LEWIS. There is always the question of what rate is reasonable, but I assure you that most firms in New Mexico would have loved to have PNM's profits last year. In fact, during a year when most businesses in this country were hurting, PNM enjoyed an 18.6 percent on the average equity. Part of that was due to a capital gain that resulted from dealings betwixt them and one of their subsidiaries.

I believe they have been fairly dealt with, and I think that is demonstrated by the fact that in a survey by Salomon Brothers—I think there are only 10 of the 50 regulatory commissions; I am assuming there is one for every State—New Mexico's commission was in the top 10 or 12 in terms of fairness to utilities, and PNM ranked 16th out of 124 utilities surveyed in actual rate of return. In other words, they weren't just looking at allowed rate of return; they were looking at actual rate of return on utility operations.

So, I think they have been very fairly dealt with, and I think that they are abusing the public's patience.

INVESTING IN NONUTILITY OPERATIONS

Senator SCHMITT. Senator, in your testimony you indicate that Salomon Brothers have noted that utilities would be better advised to use their earnings to reduce their debt and equity ratios than to invest in nonutility ventures.

Has PNM to your knowledge in recent years been reducing their debt-equity ratio?

Mr. LEWIS. Not at all, and I brought that to their attention. Part of the problem is they have so much cheap long-term debt they want to retire it, debt they floated before interest rates climbed. But I would point out that they do have extensive short-term debt that could be retired if they weren't—just recently, for example, they plowed $85 million just the other day into their nonutility operations.

Senator SCHMITT. What do you see as the advantage to the ratepayers if such debt-equity ratios are lessened?

Mr. LEWIS. Interest costs are borne by the ratepayer, effectively, the way it works. So are equity capital costs. But there is no question but that interest rate costs are passed on to the ratepayer, and it seems to me, even if it doesn't make sense to retire debt, it certainly makes sense not to take on any more.

Senator SCHMITT. Do you see any relationship between this particular aspect of the problem and the very rapid rise in rates that New Mexico electric utility users have seen in recent years?

Mr. LEWIS. It is popular in New Mexico to assume that the two are connected. I am not sure that they are. But I think what has happened in the case of PNM is that they had a very heavy capital construction program underway during the 1970's.

Senator SCHMITT. And you agree that that has been well-motivated; I mean, to get away from gas and other expensive fuels into coal ultimately?

Mr. LEWIS. To a large extent. I think they had a vested interest perhaps in being overly optimistic on demand forecasts. One person suggested to me that the effect has been that now they have tremendous excess capacity, that they are really more in the construction business than they are in the utility business, because after they build the capacity they sell the actual capacity. They don't even sell power delivered. They sell the operation, the generation plant, or an interest in it to other utilities and, as a result, they get a capital gain on a piece of property that ratepayers have financed through construction work in progress.

That may be more after the fact than before the fact. I am not at all convinced they ever planned to do that.

Senator SCHMITT. I think you are probably right. I think it is something that all utilities got caught with, over-optimistic projections for growth.

Mr. LEWIS. But I am concerned, for instance, that we may be faced with, after they have sold off all this capacity that ratepayers in the 1970's paid for, we may be forced to build a new plant next year or in the next decade because they have sold off all the capacity now.

Senator SCHMITT. Certainly New Mexico's growth projections would suggest that at some point we are going to have to build new capacity?

Mr. LEWIS. That is true.

Senator SCHMITT. But I am trying to get to the question of what does it cost the ratepayer to not retire the debt to equity ratios, or retire the least expensive debt, and, in turn, use that, the money generated there or the revenues generated there—excuse me, the capital generated there, as well as the effect of large capital gains benefits, to diversify within the State? Do you think the ratepayer would have benefited had a different strategy, investment strategy, been followed?

Mr. LEWIS. I think so, but it is a complicated issue, and I would have——

Senator SCHMITT. You are still studying that, right?

Mr. LEWIS. Yes, but I have also done enough on it to think that it is an issue. I guess the major concern is, to the extent that returns, that interest rates, effective cost of debt to the utility is higher, you have to consider taxes. That is the problem. Then equity, they would be better off, and I am not satisfied that that has really been the case. But certainly, for example—they just raised, I think it was $40 million, recently, through a new stock issue. That one they were able to sell at book value or maybe a little above, but ordinarily they haven't been recently, or in recent months anyway.

And in a situation like that they turn around and invest $85 million in these nonutility ventures. So it appears to me logical that they would not have had to issue that $40 million worth of debt. And often they have been pleading for tariff rate relief and all these other things in order to be able to issue new debt without diluting their existing equity.

I am not sure I communicated. Did I make my point clear?

Senator SCHMITT. To the degree that I understand the language that you are speaking, I think you made your point clear.

Do you know of an example of PNM or any other utility driving a private company out of business by competing in a nonregulated area?

EXAMPLES OF COMPETITION

Mr. LEWIS. I know of at least two examples in the same area. One helicopter charter operation in Albuquerque went out of business. He didn't lose his shirt, as I understand it. He told me that when he saw them get into it he just knew better than to try to stay in it himself, and he got out.

Subsequently, another operation called Aspen Helicopters came in the business. I guess actually they were in business simultaneously, but one was trying to stay in business. The president of that company, a man named Dunbar, testified before the New Mexico Legislature that he was on the verge of going out of business because of PNM's taking so much of the share of the small market for helicopter charter operations in New Mexico.

Last week or the week before, PNM announced that they were going to get out of that business. They were a little late because this guy withdrew from the New Mexico market, I believe, in April, sometime between the time—that is, between February and now. And so, it is a little too late for him. He just gave up finally after operating at a loss and transferred his operation out of New Mexico.

Senator SCHMITT. Well, is it clear in these two cases, one prospective and one not, that PNM could operate a helicopter charter service at a lower rate because of the existence of the regulated utility business?

Mr. LEWIS. Yes, partly because they already had a very high absorption of overhead because they were using helicopters themselves. And what they were doing was selling excess capacity.

Senator SCHMITT. I see. These are the helicopters that they have in order to monitor powerlines?

Mr. LEWIS. There is some question as to whether or not they have more helicopters than they need anyway. PNM has been attacked on that issue.

Senator SCHMITT. So that is somewhat of another issue, where the capital investment was justified on the basis of the utility function, and then, as with their powerplant construction, they just sell off excess capacity?

Mr. LEWIS. Exactly.

Senator SCHMITT. So the user of that capacity, in the helicopter case at least, doesn't have to pay very much on amortizing the original investment, is that correct?

Mr. LEWIS. That is right. The helicopter operator testified. He said all he knows is they have got much more effective equipment, not more efficient equipment, and they were underpricing them. I don't know what else to tell you. And he questioned their cost allocations.

Senator SCHMITT. Are there any other examples? I have heard stories about gravel.

Mr. LEWIS. There was an instance where their mining subsidiary bid on a highway project, substantially underbidding other normal sand and gravel suppliers in that trade territory.

Senator SCHMITT. Because they were engaged in stripping overburden away from coal to be mined for one of the powerplants, and they found a good quality aggregate, so they started to sell it?

Mr. LEWIS. That is right, and what I have suggested they do is that they put it for bid on the open market and let the truly private sector, the truly competitive private sector, deal with it on that basis. And that, incidentally, one of the problems there was that the people, the other sand and gravel suppliers, said they couldn't even haul it for what PNM delivered it for.

Senator SCHMITT. So, again, the basic capital.

Mr. LEWIS. So, they were using trucks that were being used in the utility operations to hold the aggregate on an empty backhaul.

Senator SCHMITT. But the two examples that you've mentioned so far are activities obviously intrastate, but could be applied interstate, but they are activities that are directly related to the utility business, excess capacity.

Mr. LEWIS. Depending on how you define it.

I have no—let's put it this way, I would have only limited objection to their supplying their own helicopter services to themselves.

Senator SCHMITT. But it is an excess capability developed by the ratepayer which then is put into competition with the rest of the private sector?

Mr. LEWIS. That's right.

Senator SCHMITT. But in other instances, where the investment is a nonutility-related business—we know about a fiberboard business, for example. Would you care to discuss that in terms of the competition with other fiberboard or similar operations?

Mr. LEWIS. Well, the primary problem in the fiberboard area is not so much on the sales side. Certainly, they will be—there's the issue of unfair competition relative to the fiberboard industry if there are no other fiberboard plants in New Mexico. It's a very capital-intensive industry. There are only 7 to 10 fiberboard plants in the entire country. So, PNM feels that they are not really competing with the locals.

However, the lumber industry, the lumbering industry in New Mexico is up in arms, because they claim that we have a scarce timber supply and that PNM's partner, joint venture partner in that fiberboard business, has been bidding up timber prices far in excess of what they should be in current market conditions. The reason is that they want to have a dependable supply for their fiberboard mill. So, we may create new jobs in Las Vegas where the fiberboard plant is, but it may be at the expense of sawmill and logging employees who will be out of work because their employer can't afford to pay the price of timber.

Senator SCHMITT. A final question, Mr. Chairman.

Tom, do you feel that it is possible, within a State like New Mexico, to fully separate nonregulated subsidiaries from the financial activities of a regulated utility?

Mr. LEWIS. I think it's probably theoretically possible, but very difficult in practice. When I heard about the situation in San Juan County, where aggregate was being supplied by the mining subsidiary, I called the New Mexico Commission and asked if they were aware of this. They weren't. They said, "Well, we never would have been aware of it had you not brought it to our attention. Our review of our books just doesn't go that deep." And in a company that size it's very difficult to get into them. In fact, even when the law has provided access, PNM in my opinion has done everything possible to thwart access. That was certainly the case last year in attempts to review their dealings with their coal mining subsidiary which supplies their plants.

And the Commission staff has indicated to me that from a practical point of view, first of all, they're not concerned about the issue of free and fair competition. They're only concerned about the effect on ratepayers, and they're not equipped to do it, it's very difficult to do.

And they also cited as an example the gas company a few years ago was under scrutiny because of some dealings with the subsidiary. I believe it was dealings with the subsidiary, I may be wrong on that. But in any case, it involved the question of access to books. The Commission wanted access to certain records, and they got into a fight with the utility over the provision of it. And the Commission finally won, but they didn't win, because what happened is the utility backed up about four semitrailers to the Commission offices and said, "Here are our books, you can find it." From a practical point of view, it's just very difficult to do.

Senator SCHMITT. Well, thank you, Tom, for your testimony. We may have some questions for the record from my office.

Thank you, Mr. Chairman.

Senator D'AMATO. Senator, before we conclude these hearings, let's say that your testimony, I think, focuses on the heart of the problem. And the panel that preceded you helped to focus the issue: Can we make it easier for public utilities to discharge their responsibilities and duties? If they can be more effective and efficient and if we can reduce the regulatory burdens of the act, obviously the fruits of this effort could be better productivity and, hopefully, lower rates to the ratepayer in the long run. So, we all stand to benefit.

DECISION OF AMENDMENT OR REPEAL

The question that is raised is whether we can amend the act to deal with those regulatory problems and burdens; will that be sufficient? Might it inadvertently strip away some of the protections that exist for small business—a question that has been posed today. And would total repeal of the Public Utility Holding Company Act open the door to practices that presently exist within your State, recognizing that this act has not precluded that kind of activity?

So, it is a difficult question, a question that is going to, I am sure, test not only our staff but the members of this committee and the entire Congress. It's one where we do owe the public an answer, and we owe the industry a comprehensive review and an answer to the question put before us.

Let me also conclude by saying that it is obvious that the training that one has received in a great institution, Cornell, in the State of New York, has benefited the people and the State legislative process in New Mexico invaluably. [Laughter.]

And I might call that to my learned colleague's attention. And I am certain that the people of New Mexico are delighted that you have had that opportunity once again to return to their fair State.

Mr. LEWIS. They're particularly happy they didn't have to finance it, Mr. Chairman.

Senator D'AMATO. Let me thank you for your testimony and shedding light, as you have today, on this complicated problem.

Senator Schmitt.

Senator SCHMITT. Mr. Chairman, in addition to your comments about the educational institutions back East, New Mexico has sent many of its sons back East to get an education. But we send some of them West, too. I happen to believe the wind blows in both directions.

One of the things though I hope the committee can see, and that is that in New Mexico there is a microcosm if you will of the national problem related to diversification. It is a source, as I'm sure other States are—a source of information on what kind of problems may develop if we provide a broader capability for interstate diversification by public utilities. At the same time, I think it's important that New Mexico work out its problems internally. Tom and I may or may not disagree on this. We haven't discussed it. But I do think, in New Mexico, people like Tom in the legislature are capable of handling the intrastate diversification problem. We will figure that out. We will work out a scheme that I hope and believe will be the best for New Mexico.

Whether there should be legislation related to such intrastate diversification at the Federal level or not is a real question, but one that I would almost instinctively come down against.

I believe that we can handle it, I believe New York can handle their problems and that we need to stick with the other issue, and that is a discussion of whether or not there is any advantage to broad intrastate diversification authority for the public utilities.

Senator D'AMATO. I think the Senator's sentiments are very much shared and appreciated by the Senator from New York—I know they are—in terms of interstate, as opposed to intrastate regulation.

I might touch on one comment I made a note to myself about, coal mining. Obviously, you're not opposed, nor does the act prohibit coal mining as an activity, particularly when it is an integral part of supplying energy and potential energy sources to the utility itself.

Now, the fact that a utility might have the ability to sell excess coal and might even, indeed, enhance its total operation and total efficiency, should also be considered. So, one would not argue against, for example, diversification which enhances power supply.

Mr. LEWIS. Mr. Chairman, the bill that I introduced, which passed the New Mexico Senate, would have allowed PNM to continue in the coal business. But as I expressed to Senator Schmitt this morning, I'm not entirely comfortable with that, even though initially I had taken that position, because of the demonstrated record of keeping a handle on it.

And I would argue I think you can always find somebody to mine your coal for you if you just want to. I mean, for example, in the case of this fiberboard business, PNM is saying, "Well, we're going to develop an industry that wouldn't otherwise have been developed."

My question is: Did they ever go out and really try to recruit anybody else? The evidence indicates that they haven't.

I think sometimes utilities say, we've got to get into the coal business to take care of ourselves because nobody else will, and they've never really tried to.

Senator D'AMATO. Certainly, Senator, you can see the distinction—a clearcut distinction between going into the fiberboard industry as opposed to the coal industry or the development of atomic power or uranium mines, where there is a direct relationship, and a direct benefit that can be attributed and direct savings to the utility and its ratepayers could result. I think there's a clear-cut distinction.

BENEFITS EXAGGERATED

Mr. LEWIS. I agree. It's not something that I'm instinctively opposed to; OK? What I'm trying to say is I think the benefits of vertical integration are sometimes exaggerated. I would point out that in the oil industry there's been a move away—particularly in New Mexico, there are far more independent marketers of gasoline than there were a few years ago.

I think often if there's a big enough market, a big enough scale of economic activity, you can get enough competition in there, and you can get three coal companies trying to supply the utility with coal, and here's the utility's coal supplier, their subsidiary. And I think that probably benefits ratepayers more than having to do that themselves. But I would not arbitrarily say that they cannot supply their own fuel, no. I'm trying to say it's something to be very wary of.

Senator SCHMITT. Mr. Chairman, I think Mr. Lewis, in his testimony, has really brought out though a significant problem that comes with that. And I don't know the answer. But if a public utility such as Public Service of New Mexico develops a coal mining capacity and it is in excess, as soon as it's in excess, whatever the justification may have been, and good justification, for having it in the first place, it immediately competes with York Canyon's strip mining and boiler coal. York Canyon is a Kaiser-owned subsidiary in northern New Mexico that is looking for coal markets right now, and they're going to have a 3-week shutdown, I think, right now because of the dropoff in the coal market of one of their purchasers. But all of a sudden you get to that point, and you got to that point with gravel.

Removing the layer of overburden over all stripable coal is a part of the coal mining operation. But suddenly you create a new resource, that's gravel, that's aggregate. What do you you do with it? If it's sold and all the overhead costs have already been paid, if it's sold and undercuts the rest of the sand and gravel market in a State like New Mexico, then, is that something that a public utility ought to be able to do? And I don't have an answer for you. And I can sympathize with some degree with Public Service of New Mexico when they may, with all good faith, take on a job and then discover they have excess capacity to produce something else or produce power. And then, what do you do with it?

Senator D'AMATO. If I might follow up, how do the various regulatory bodies, when faced with this decision, decide?

Do they attempt to bar a company that makes the claim that it is necessary for their orderly operation, let's say, whether it's to mine coal or get into the uranium business?

And if they once allow such an activity to take place and the legislature approves such an activity within that State, obviously, the excess produced can become a burden and a liability if not disposed of in the open market. And, obviously, it might provide unfair competition if allowed to be disposed in the free market system, and that really is the problem we have to decide.

Mr. LEWIS. I guess we're hitting the nub of the issue, Mr. Chairman. And that's why I'm trying to say that I think that monopoly—any firm granted a monopoly should be allowed to operate only within the scope that's absolutely necessary to perform the monopoly function efficiently and that government's role in the marketplace should be to assure businesspeople that they will not be protected from competition but be protected from unfair competition and let them have at it.

If U.S. Steel wipes out a small coal supplier, assuming there are no subsidies or government policies that promoted that, it's unfortunate; but presumably the more efficient company has survived.

Senator SCHMITT. Mr. Chairman, I think it's an interest here, and I would call the attention of the subcommittee to the work over several years that we have done in the Commerce Committee in attempting to work out almost identically the same problem relative to AT&T.

There, Senate bill S. 898, after those years of deliberation and trying many different tacts, takes the position that it is possible, at least in the communications industry, to develope fully separate subsidiaries that are, in terms of the financial activities, are fully separate. And that is, of course, the basis for that bill.

Whether that can work in a far more intimate way within the State, or even work with respect to a much less nationally integrated public utility industry, I can't tell you. I just draw your attention to that tact that we took with respect to AT&T. and look at it and see if that supplies any light at the end of any tunnels.

Senator D'AMATO. I might note the fact that the prior witness was Assistant Attorney General Baxter. [Laughter.]

Senator SCHMITT. Yes; I heard that.

Senator D'Amato. Who testified and advocated the total repeal of the Public Utility Holding Company Act. Maybe——

Senator Schmitt. Well, that's a very interesting position by Mr. Baxter. I'll study it with great interest, particularly in relation to the situation he has created—or at least, that he has created through his position in the Justice Department, relative to the communications industry, which was to take the position that neither the House nor the Senate, nor anybody else, had decided was an appropriate one. And that is: To force divestiture of the operating companies of the Bell System.

I do not think that's an appropriate mechanism. I think it's fraught with difficulties, not only for the local ratepayers but also fraught with difficulties for the continued viability of a high-technology communications industry in this country.

Be that as it may, I am not sure that I, personally, think that Mr. Baxter is a very good witness on issues related to monopoly activities in this country.

Senator D'Amato. Maybe the Committee will invite Mr. Baxter back and we'll have the able Senator from New Mexico to pose to him certain questions.

Senator Schmitt. We have discussed these issues before, Mr. Chairman.

Senator D'Amato. Let me, at this time, say to the Senator from New Mexico, thanks, first of all, for putting, I think, some very real perspective on the State side of this matter and the practical aspects of what he has seen take place in his State.

He's, obviously, a student of this situation. And, as Senator Schmitt has indicated, he is someone who is probably one of our more able, if not the most able, State legislator in this area in terms of his expertise.

Thank you very much for sharing with this committee your knowledge in this matter.

The subcommittee will now stand in recess until Thursday.

[Whereupon, at 12:05 p.m., the subcommittee was adjourned, to reconvene on Thursday, June 10, 1982.]

PUBLIC UTILITY HOLDING COMPANY ACT AMENDMENTS

THURSDAY, JUNE 10, 1982

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, D.C.

The subcommittee met at 9:45 a.m. in room 5302 of the Dirksen Senate Office Building, Senator Alfonse M. D'Amato (chairman of the subcommittee) presiding.

OPENING REMARKS BY SENATOR D'AMATO

Senator D'AMATO. Our subcommittee will come to order.

This morning the subcommittee will continue its review of the Public Utility Holding Company Act. During the previous 2 days of hearings, we have heard some lively debate over the merits of repealing or amending the statute, from a number of distinguished witnesses. Questions have been raised about the extent to which the act is merely duplicative of other State or Federal law, about the need for Federal intervention in management of utility systems, about the consequences of utility diversification.

We will explore these and other issues further today. We are very pleased to have with us this morning: The attorney general from the State of Rhode Island; a panel of utility executives, representing a registered company, an exempt company, and an independent operating company; a panel of two executives representing highly diversified utilities; and a securities analyst specializing in utility financing.

For our first witness, I am delighted to call Mr. Dennis Roberts, the attorney general of the State of Rhode Island.

STATEMENT OF DENNIS ROBERTS, ATTORNEY GENERAL, STATE OF RHODE ISLAND

Mr. ROBERTS. Good morning, Mr. Chairman.

I am privileged to have the opportunity to appear this morning before the subcommittee. I am doubly privileged, when I review the list of other witnesses who either have appeared or will appear before the subcommittee during these hearings. Certainly, they are all people with a great deal of important information to bring to the attention of the subcommittee in these proceedings.

I should perhaps begin my remarks by introducing myself and my function: I am, in fact, the attorney general of Rhode Island. My personal professional background has been substantially in the area of rate regulation, including Federal rate regulation before the Federal Energy Regulatory Commission and its predecessor, the Federal Power Commission.

As attorney general and as the attorney for the people of the State of Rhode Island in those proceedings, we have had significant opportunity to involve ourselves in the rates to be charged by the New England Power Co. and the Montauk Electric Co., two public utility companies which provide basically 100 percent, through affiliates, of the electric energy consumed by the citizens of the State of Rhode Island.

I think in the degree of market saturation that holding companies enjoy in the State of Rhode Island, we probably are No. 1 in the country among those States dependent upon the service of affiliates of holding companies.

For that reason, the proposal to amend or repeal the act represents a very serious potential for disarranging and degrading the Nation's regulatory structure. It appears to us that the very success of the act in controlling abuses and offering an important check on utility management has led to a sense that it's no longer needed.

In this regard, I thought it would be significant to this committee to add my views and experiences on the record which you are now developing. I can bring to you not only the views of myself as a State official concerned with regulation, but also specific information in New England, where the market saturation is so great.

At the outset, I wish to associate myself strongly with the statements of concern and the arguments advanced before this subcommittee and the House subcommittee, by groups such as the American Public Power Association, opposing the proposals to repeal or amend the act.

REPEAL COULD BE EXTREMELY DISRUPTIVE

A careful review of these proposals leads, I believe, only to the conclusion that the act is a vital part of the Nation's overall regulatory structure and that the probable consequences of its repeal would be, at the very least, extremely disruptive. At a time when the Nation's economic situation—and sharp increases in energy prices—are placing serious strains on all energy consumers, it seems particuiarly ill-advised to embark upon a dubious venture such as this.

Now, this is particularly true, it seems to me, if we apply a cost-benefit analysis, Mr. Chairman, because the benefits that will accrue to the utility companies if the act is repealed are small, very small, in fact, in relationship to the scale of the industry as a whole.

In testimony before this subcommittee yesterday, Alan Richardson showed that the annual cost to registered holding companies is under $5 million per year. These same companies control nearly 20 percent of the Nation's utility industry, with assets of over $48 billion and operating revenues over $16 billion.

The costs to the Government, in the context of the Nation's overall regulatory budget, are also extremely small.

In Rhode Island and southeastern New England generally, we are in fact, as I have indicated, very substantially directed and impacted by holding companies themselves. We estimate that some 70 percent of the electric rates paid by the ultimate consumer in the State of Rhode Island—and, I suspect that would be true in areas of Massachusetts, such as the southeastern and central Massachusetts areas—are regulated directly by FERC, through purchase power cost adjustment clauses that flow through federally approved rates—and in some cases, of course, federally not-yet-approved rates, where rates have gone into effect subject to refund through to the ratepayer.

We know that the two companies which service our area, particularly New England Electric System, which is represented here this morning by Mr. Guy Nichols, its very able chairman, have, in fact, begun to expand rather sharply into related business. For example, NEEI, which I believe is New England Energy, Inc., is an affiliate of the New England Electric System, concerned with fuel procurement, coal procurement, and so forth.

All of these efforts toward diversification have been accomplished quite successfully within the scope and the limitations of the present draft of the 1935 act, which apparently is not a detriment at all to making these extentions into related utility business, under the strictures of the act.

There is, obviously, no reason—we do not object to these activities, since they could be of benefit to all concerned. But there is also a risk imposed, a significant risk, that these ventures may adversely impact the consuming public. Further, the continued activity of these and other utility holding companies in areas coming within the act provides one of the reasons why it remains an important element of the overall regulatory system.

The regulatory situation in my State, and in New England, generally, is relatively complicated. As we in Rhode Island view the Public Utility Holding Company Act, it provides us with regulatory review of subsidiary transactions, where there's a lack of arm's-length bargaining—it controls the impulses of utility management toward risky forms of diversification—and it represents a force in the direction of reasonably simple financial structures.

Especially during times when acquisition, diversification, and the creation of conglomerate enterprises are in style in the business community, this type of restraining influence provided by the act is appropriate, if only to make utility management think twice before it charges off with the herd.

None of these checks and protections are available to our consumers and State officials elsewhere in the overall regulatory structure, in the absence of this act.

CHARGING RATEPAYERS FOR INVESTMENT FAILURES

Most recently in Rhode Island and southeastern New England generally, one of the principal controversies surrounding us has been the move by utilities to charge the ratepayer for investments in plants which have failed—namely, the nuclear stations. I think one which is very much in litigation, very much in controverly right now, is the proposal by various participants, including holding companies, as well as the Boston Edison Co., to charge off the cost of an unsuccessful investment in Pilgrim 2 nuclear station.

Pilgrim 2, unfortunately, is not unique. In the case of one of the companies servicing our area, Montauk, we have seen recently a FERC order awarding extraordinary relief, which we contend respectfully is in error, under circumstances where there were a complicated series of filings, resulting in an award that will be passed on directly to the ratepayers, to the extent of at least 70 percent—under circumstances where, as we say, subsidiary controls exerted over the capital structure, for example, of the Eastern Utilities Associates will be of use to us in State regulation and State enforcement as, if you will, a backup check to whatever action might eventually be taken on review by the Federal Energy Regulatory Commission.

If we have any problem, Mr. Chairman, with this act, in our judgment it is a problem with lack of vigorous enforcement of the act at the Federal level.

Five or six years ago—I believe it was 1977—you will recall a study by the General Accounting Office which warned against a tendency to underutilize the enforcement responsibilities conferred by the SEC by the act. In my judgment, that is a situation which has not improved to this day.

With my testimony, Mr. Chairman, I have filed—and I hope it's with the chairman and the counsels' copies—a letter which was prepared by George Spiegel of the firm of Spiegel & McDiarmid. He has authorized me to file this letter, narrating a series of instances in which the act has operated to the distinct benefit of consumers.

I would like, although I didn't prepare that letter, to incorporate that into the record of this hearing.

Senator D'AMATO. It will be inserted into the record.

[Mr. Roberts' prepared statement and the documents referred to follow:]

STATEMENT OF

ATTORNEY GENERAL DENNIS J. ROBERTS, II
ON THE PUBLIC UTILITY HOLDING COMPANY ACT
BEFORE THE SUBCOMMITTEE ON SECURITIES
OF THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
OF THE UNITED STATES SENATE

June 10, 1982

Mr. Chairman and members of the Subcommittee, I appreciate the opportunity to testify regarding the proposals to amend or repeal the Public Utility Holding Company Act of 1935 (the Act). As Attorney General of the State of Rhode Island -- and in my prior experience in both the public and private sectors -- I have become intimately familiar with issues surrounding the effective regulation of the utility industry in the public interest. Regulation of businesses which are, by their nature, natural monopolies -- particularly when those businesses operate across state lines -- requires a complex balancing of interests and responsibilities. The system which has evolved over many years is not without defect but it does represent an accumulation of experience and apportionment of responsibility designed expressly to balance public and private interests.

The proposal to amend or repeal the Act represents a serious potential for disarranging and degrading the nation's regulatory structure. It appears that the very success of the Act in controlling abuses and offering an important check on utility management has led to a sense that it is no longer needed.

In this regard, I thought it would be important to this Committee -- as well as a contribution to the current discussion of utility diverisification -- to add my views and experience to the record which you are developing. I can bring to you not only the views of a state official concerned with utility regulation but also some specific information about the situation in New England where, especially in the electric utility field, utility holding companies are currently very active and represent such an important portion of our overall energy supplies.

At the outset, I wish to associate myself strongly with the statements of concern and the arguments advanced before this Committee and the House Subcommittee on Energy Conservation and Power by groups -- such as the American Public Power Association -- opposing the proposals to repeal or amend the Act. A careful review of these proposals leads, I believe, only to the conclusion that the Act is a vital part of the nation's overall regulatory structure and that the probable consequences of its repeal would be, at the very least, extremely disruptive. At a time when the nation's economic situation -- and sharp increases in energy prices -- are placing serious strains on all energy consumers, it seems particularly ill-advised to embark upon a dubious venture such as this.

This is particularly true because the alleged benefits which will accrue to the utility companies from the repeal of the Act are so dubious. Those benefits which can be quantified are extremely small in relationship to the scale of the industry as a whole. As Mr. Allen Richardson pointed out in his testimony yesterday before the House Committee, the annual cost to registered holding companies is under $5 million per year. These same companies control nearly 20% of the nation's utility industry -- with assets of over $48 billion and operating revenues in excess of $16 billion. The costs to the government, in the context of the nation's overall regulatory budget, are also extremely small.

In regard to the more indefinite arguments advanced by the utility industry for repeal of the Act -- such as lost opportunity costs and the alleged benefits of diversification -- these must be balanced against any decision to eliminate one of the major elements of the carefully erected regulatory system. As you have been informed in other testimony, the National Association of Regulatory Utility Commissioners has reviewed the diversification issue over a number of years and has made numerous significant and serious arguments against its alleged contribution to the economic health of the utility industry.

In Rhode Island -- and southeastern New England generally -- we are very directly affected by this question because a substantial amount of the area's utility industry comes within the Act. Specifically, virtually all of the electric energy supplied to the State of Rhode Island comes from the New England Electric System and Eastern Utilities, both of which are active holding companies. One of these companies, New England Electric, is currently showing a strong tendency to diversify into related utility businesses. This related diversification in the area of fuel procurement (NEEI) and fuel handling appears to be quite successful to date and has been accomplished within the constraints of the Holding Company Act. Both companies have also shown an interest in possible mergers. There is obviously no reason to object to such activities per se -- they may well be beneficial to all concerned -- but there is also no reason why they should not be subject to reasonable scrutiny because of the significant risk such ventures may imply for the consuming public. Further, the continued activity of these and other utility holding companies in areas coming within the Act provides one of the reasons why it remains an important element of the overall regulatory system.

The regulatory situation in the Rhode Island area -- and in New England generally -- is fairly complicated. It may be helpful to the Committee for me to note on the record that the Federal Energy Regulatory Commission effectively sets approximately 70% of the utility rates charged within the State of Rhode Island. This fact obviously underlines our concern with the adequacy of federal utility regulation, because so much of the utility activity affecting our area is interstate in nature and, therefore, beyond effective regulation by state agencies.

As we in Rhode Island view the Public Utility Holding Company Act, it provides us with regulatory review of subsidiary transactions where there is lack of arms-length bargaining -- it controls the impulses of utility management towards risky forms of diversification -- and it represents a force in the direction of reasonably simple financial structures. Especially during times when acquisition, diversification and the creation of conglomerate enterprises are "in style" in the business community, this type of restraining influence is appropriate if only to make utility management think twice before it charges off with the herd. None of these checks and protections are available to our consumers and state officials elsewhere in the overall regulatory structure.

We in Rhode Island have been asked by public utility management to pick up the tab for hundreds of millions of dollars of management decisions that went wrong, as one generating plant after another was cancelled. The cost to Rhode Island's ratepayers has been enormous, and is likely to go higher.

If, in a diversified setting, similar investments are undertaken with similar results, who will bear the cost? Ultimately, in one way or another, the utility ratepayers will pay, either in higher utility rates, in a diminished ability to render utility service, or both.

A specific example of the continuing problems created by utility holding companies is provided by a case which is presently pending before the Federal Energy Regulatory Commission. One of the holding companies serving Rhode Island and southeastern New England applied for a wholesale rate increase and extraordinary interim relief in a complex series of filings. In an order awarding the requested extraordinary financial relief to the utility, the Commission has, in my view, seriously misunderstood the operation and implications of the financial and organizational structure adopted by the utility. The result is a grossly unfair burden upon ratepayers for which there appears to be no recourse at the Commission. The presence of the Public Utility Holding Company Act and the involvement of the SEC represents virtually the only opportunity to evaluate the organizational structure chosen by this utility if it appears likely to continue to frustrate reasonable regulation -- and the Act may well come into play in this particular instance.

If there is any problem with the Act, in my view, it is the need for more vigorous enforcement. I recall a study by the General Accounting Office released in 1977 which warned against the tendency to underutilize the authorities and responsibilities conferred upon the SEC by the Act and I have a strong concern that this continues to be the case. I am somewhat doubtful that it is the SEC itself which is among the leaders pressing for its repeal.

I recently had the opportunity to review a very interesting and detailed letter provided by George Spiegel, of the firm of Spiegel & McDiarmid, to the American Public Power Association relating to the proposal to repeal or amend the Act. In this letter, Mr. Spiegel, who is a senior practitioner in the area of public utility regulation, details several instances in which the Act has operated to the distinct benefit of consumers -- and a healthy utility industry, I might add -- in New England. Mr. Spiegel has authorized me to provide a copy of this letter to your Committee as an element of my testimony and I believe it is worth your careful consideration.

Basically, I think that the situation is that only a holding company statute -- expressly the legislation under review today -- can really be responsive to the situation created by the existence of the holding companies. The issues which caused the passage of the legislation in 1935 are still present in utility management and regulation -- and the power to deal with these issues is not duplicated elsewhere in the nation's regulatory structure.

I find the fact that the Public Utility Holding Company Act and the Federal Power Act passed the Congress as companion pieces of legislation and were designed to operate in tandem especially compelling when the question is raised as to whether the former should be repealed. From my substantial experience in utility regulation -- and my present perspective as Attorney General of the State of Rhode Island -- it is my strong opinion that the 1935 Act is a significant component of our state/federal regulatory scheme. Speaking on behalf of utility consumers, I am deeply concerned by proposals to alter this major component of the scheme. The particular situation involving utility holding companies which prevails in Rhode Island and New England helps to underline the reasons for this concern -- there are comparable situations in other parts of the country which, I believe, point to the same conclusion. I urge the members of this Committee to consider these proposals with great care because of the substantial and far-reaching consequences which I believe will inevitably arise if this protection to the consuming public is significantly altered or removed.

LAW OFFICES
SPIEGEL & MCDIARMID
2600 VIRGINIA AVENUE, N.W.
WASHINGTON, D.C. 20037
TELEPHONE (202) 333-4500
TELECOPIER (202) 333-2874

GEORGE SPIEGEL, PC
ROBERT C. MCDIARMID
SANDRA J. STREBEL
ROBERT A. JABLON
JAMES N. HORWOOD
ALAN J. ROTH
FRANCES E. FRANCIS
DANIEL I. DAVIDSON
THOMAS N. MCHUGH, JR.
DANIEL J. GUTTMAN
PETER K. MATT
DAVID R. STRAUS

OF COUNSEL
SUSAN T. SHEPHERD

RON M. LANDSMAN
BONNIE S. BLAIR
THOMAS C. TRAUGER
JOHN MICHAEL ADRAGNA
CYNTHIA S. BOGORAD
GARY J. NEWELL
MARC R. POIRIER
MARTA A. MANILDI
JOSEPH L. VAN EATON
STEPHEN C. NICHOLS
PATRICIA E. STACK
P. DANIEL BRUNER
SCOTT H. STRAUSS
NANCY E. WIEGERS

June 4, 1982

Allen H. Richardson, Esq.
General Counsel
American Public Power Association
2301 M Street, N.W.
Washington, D.C. 20037

Re: Legislation Intended To Repeal The Public Utility Holding Company Act of 1935.

Dear Mr. Richardson:

You have asked me to convey my views regarding the continued need for the Public Utility Holding Company Act of 1935 ("PUHCA" or "Act") and the proposed legislation which would repeal PUHCA. In my opinion, PUHCA remains of vital importance to the proper regulation of the electric and natural gas utility industries and should not be repealed. To support my conclusions, I offer the following proceedings and related matters which illustrate the need for vigorous enforcement of PUHCA.

Prior to addressing the specific proceedings which I believe fully demonstrate the continued need for PUHCA, some generalizations are appropriate. Initially, I note that the incumbent Commissioners of the Securities and Exchange Commission ("SEC") have expressed the view that the work under the Act has been completed and that PUHCA no longer serves a useful purpose. In my opinion, the current Commissioners lack a historical perspective and misread the calm waters, failing to recognize that the Act, like a dam, has created the calm. Without the Act, the crucial natural gas and electric industries would become subject to merger and take-over abuses. For example, oil companies would be free to take over electric utilities, thereby diminishing the already inadequate market competition by utilities in the purchase of oil, gas, coal and nuclear fuels. Currently registered holding companies could take advantage of their exclusive power pools and the efficiencies and economies of their bulk power resources to take over smaller companies, rather than deal fairly with them in power supply matters. Subsidiary companies could be created to siphon off benefits that should flow down to the consumers because the Act's prohibitions against unrestrained intra-system profits would be abolished. These are problems which conventional regulatory bodies were unable to address and control prior to the enactment of PUHCA and there is no reason to believe that existing state and federal regulators would be equal to the job today. In fact, only the SEC is capable of addressing holding company abuses and the present comparative absence of holding company abuses are only evidence of the deterrent effect of this crucial statute.

In this regard, it should be acknowledged that a few states have enacted legislation which prevents undesirable mergers and holding company proliferation. However, irrespective of such state statutes, no single state regulatory commission can effectively deal with a multistate holding company and joint state action is difficult to achieve. For this reason, I believe only the SEC can effectively regulate multi-state holding companies.

A good example of the type of abuse which could arise upon repeal of the Act would be the sale of fossil or other fuels by an oil company to its captive electric utility subsidiary. It is submitted that conventional regulatory resources are inadequate to investigate and resolve such probable holding company abuses because existing agencies lack the facilities and funds to sift through the complex data which would be created to mask the preferential fuel contracts.

As to the particular proceedings which demonstrate the continued need for and the utility of PUHCA, I have divided my response according to the functions fulfilled by the Act.

MERGERS

The enactment of PUHCA represents a Congressional determination that the extraordinary growth of holding company systems was against the public interest. By its terms, the Act abolished public utility holding companies which did not comply with the integration standards expressed in Section 11. Expansion of registered and some exempt holding companies is subject to Section 10 of the Act. This provision contains detailed requirements for any new public utility holding company expansion which are intended to nip in the bud any recreation of the circumstances that prompted enactment of the statute.

In administering Sections 10 and 11 of the Act, the Securities and Exchange Commission ("SEC") has refused to approve mergers which were not in the public interest and conditioned its approval of otherwise inappropriate mergers in a fashion designed to encourage competition in the utility industry between investor-owned and municipally-owned electric systems. These actions have spared the public the recreation of large, inefficient holding companies which are not amenable to effective state or federal regulation. Further, the PUHCA has encouraged a healthy plurality in the electric utility industry which would not otherwise exist.

A good example of the SEC's commendable actions in this regard is its comparatively recent disapproval of the proposed Eastern Electric Energy ("EES") merger. The New England Electric System, Boston Edison Company and Eastern Utilities Associates proposed to merge. These entities were, respectively, the second, third and seventh largest electric systems in New England and controlled more than 40% of the region's generating capacity and electric sales. After proceedings in which the antitrust division of the Justice Department was a party, the SEC spared the public the inefficiencies of bigness and ruled that the proposed merger would not "serve the public interest by tending toward the economical and efficient development of an integrated public utility system ..." within the meaning of Section 10(c)(2) of the Act. 1/ More particularly, the SEC ruled that consolidated operation of these three large holding companies would not yield operating efficiencies sufficient to meet the standards of the Act.

Of equal importance to the long-term development of a more efficient electric utility industry was the SEC's conclusion that all of the benefits attributed to the merger were available through power pooling. Of course power pools are the arrangements by which two or more utilities agree to coordinate a portion of their operations to realize maximum operating efficiency. In the context of the EES merger, the SEC concluded that the New England Power Pool offered the New England region all of the benefits of economies of scale in the generation and transmission of power with none of the burdens to the consumer resultant from the affiliation and its attendant corporate growth.

1/ New England Electric System, Eastern Utilities Associates, Boston Edison Company, Eastern Electric Energy System, Order Denying Application; Findings and Opinion of the Commission; Docket No. 70-4663, File No. 3-1698 (February 4, 1975) Holding Company Act Release No. 18801.

Obviously, if PUHCA were repealed the EES affiliation could have been consummated without SEC scrutiny and the public interest could, thereby, have suffered owing to the absence of any other agency fully prepared to deal with holding company mergers. More importantly, if PUHCA were repealed an important regulatory barrier to inefficient mergers would be eliminated. Given the importance of the electric and natural gas industries to this country, it is apparent that repeal of the Act would be detrimental to the public interest on this basis alone.

Another merger proceeding which demonstrates the continued importance of the Act is the acquisition by the American Electric Power Company ("AEP") of the Columbus and Southern Ohio Electric Company. As you are aware AEP is the largest electric utility in the industry. The Antitrust Division of the Department of Justice and the SEC Staff opposed the merger on the grounds that it would violate the policies of the antitrust laws which are embraced by the public interest standards of PUHCA. The Ohio Municipal Electric Association intervened in the proceeding as well and asserted that the merger would adversely effect competition in the bulk power market in Ohio and thereby supported both the Antitrust Division and the SEC Staff.

This proceeding was unique because it attracted the participation of several investor-owned utilities which stood to be damaged by approval of the merger. The damage which was feared would arise from the termination of Columbus and Southern Ohio's participation in a regional power pool and the resultant loss of economies of scale.

The record of this merger proceeding benefited from a thorough investigation of AEP's prior acquisitions and acquisition policies. That investigation and the documentary evidence which was produced speaks for itself regarding AEP's past acquisition programs.

This proceeding was ultimately terminated by a negotiated settlement. The broad settlement reached severally between AEP and the Ohio municipals, and Ohio cooperatives, became a condition of the acquisition order and has lead to mutually beneficial power supply and transmission arrangements along with what generally appears to be good business relationships which augur well for the future. This is a very positive result of SEC's enforcement of the Act. The other Ohio investor-owned utilities, to the extent the level of their participation in the proceeding did not produce all the conditions necessary to protect them from future forced acquisition activity, can look to the proceeding as precedent for future protection.

The case illustrates the importance of preserving the protections of the Act for programs of the large registered holding company systems which, by exercise of their dominant regional power supply, transmission, and pooling positions, are able by coercion in power supply matters and/or the availability of financial power to induce or force the acquisition of neighboring systems, whether they be investor, municipal or cooperatively owned.

The final merger matter which I believe is relevant to the pending legislation is the proceeding by which Northeast Utilities was created. This merger involved the consolidation of two Connecticut and two Massachusetts electric utilities and, owing to the multistate character of the merger, could not have been accomplished under state law.

While this merger was promptly approved, the importance of the SEC's actions under PUHCA lies in the fact that the consolidation of the four utilities was conditioned upon Northeast Utility's assurance of a high voltage interconnection between one of its operating companies and the City of Holyoke Gas and Electric Deparment ("Holyoke"), which was an intervenor in this merger proceeding. The SEC also ordered Northeast Utilities to give Holyoke access to the Connecticut Valley Electric Exchange ("CONVEX"). Previously, Holyoke was isolated electrically and subject to the continued take-over efforts of the Holyoke Water Power Company. Since the merger, interconnection and entry into CONVEX, Holyoke has enjoyed excellent financial health, the take-over effort has ceased, and Northwest Utilities has benefited business-wise from its transactions with Holyoke. Further, Holyoke's success in breaking into the CONVEX pool was a major milestone to the development of the New England Power Pool to which all New England electric utilities have reasonably fair access, whether large or small, or investor, muncipalically or cooperatively owned. I believe that this proceeding illustrates that the beneficial results of SEC enforcement of PUHCA are not always visable.

COMBINATION GAS AND ELECTRIC SYSTEMS

The SEC and the Courts have construed Section 11 of the Act to prohibit combination electric and natural gas utility holding companies because it was concluded that Congress wished to promote competition between gas and electric utilities as a means of improving utility service and minimizing utility rates. 1/ The continued vitality of the Act is demonstrated by this statutory prohibition against combination utility holding companies. History taught the Congress that such combined operations were detrimental to the public interest and repeal of the Act should not occur without a careful analysis of the potentially damaging effects of suspending this important feature of the PUHCA.

BULK POWER MONOPOLIES

As is evident from the discussion above, PUHCA is a quasi-antitrust statute which was enacted in response to the abuses of the very large utility trusts which grew up over the years. By the enactment of PUHCA Congress successfully sought to deter the recreation of large holding companies which exercised monopoly power over essential utility resources, such as large generating units which yield economies of scale. A good example of Congress' success in this endeavor is provided by Municipal Electric Association of Massachusetts v. SEC, 413 F.2d 1052 (D.C. Cir. 1969). This litigation involved the efforts by all or virtually all of the investor-owned utilities of New England to retain for themselves the benefits of atomic generating resources. More particularly, the New England investor-owned utilities sought to create new holding companies for the purpose of the exclusive development of atomic generating resources in the region. Under their proposals, only the investor-owned utilities would have the opportunity to purchase interests in the new entities and thereby the investor-owned utilities would retain control over this low-cost generation. The Court ruled that PUHCA would require open access to the generating companies, if the complaining Massachusetts municipal electric systems showed that excess concentration and control would result from exclusive ownership by the investor-owned utilities.

On remand, a relatively short but thorough investigation motivated the investor-owned utilities to offer all utilities in the New England region the right to purchase ownership interests in the atomic generating units. Further, another effect of this proceeding was to lay the foundation for regional power pooling and the benefits of the New England Power Pool may, in part, be attributed to the enforcement of the Holding Company Act in this proceeding.

1/ SEC v. New England Electric System, 384 U.S. 176 (1966) and Philadelphia Co. v. SEC, 177 F.2d 720 (D.C. Cir. 1949).

The importance of Municipal Electric Association of Massachusetts and PUHCA cannot be overstated. In the absence of PUHCA, a monopoly over bulk power resources would have evolved, and power pooling advancements would have been lost. In the future, similar attempts to preserve for the few the benefits of innovation may well arise and if PUHCA is repealed the detrimental effects to the public interest would be profound.

REGIONAL POWER POOLING AND OPERATING EFFICIENCIES

Apart from its antitrust features, the Holding Company Act was intended to promote efficient utility operations and regulation. Congress had found that many utility holding companies were inefficiently operated and the integration standards of Section 11 were enacted with a view of requiring those holding companies which survived to operate in a coordinated and efficient manner. Another objective was to ensure that those holding companies which survived would be adequately regulated, it having been determined that existing federal and state regulation were inadequate to control holding companies.

It might be assumed that these efficiency criteria are not of current importance. However, recent proceedings before the SEC concerning the Central and South West Corporation ("CS&W") and Texas Utilities Corporation ("TU") illustrate the continued importance of these features of the Act. Thus, certain municipal customers of a C&SW subsidiary complained to the SEC that the electric rates paid by all southwestern consumers were artificially and substantially inflated because C&SW, TU and the remaining Texas utilities operated in isolation from the remainder of the United States to avoid federal rate regulation. The complaining municipal customers asserted that C&SW contributed to this situation because its Texas subsidiaries were operated in isolation from its remaining two subsidiaries and that such conduct constituted a violation of the integration requirements of Section 11 of the Act. These same municipal systems alleged that TU was a primary cause of the situation and urged that its exemption from the Act be revoked.

These same parties estimated that the additional cost to all southwest consumers of isolating Texas from the United States cost southwestern consumers $100,000,000 per year.

The SEC instituted proceedings and in response thereto C&SW conducted studies to test the accuracy of the assertions that its non-integrated status inflated rates substantially. C&SW's studies showed that substantial operating economies would be achieved if C&SW, TU and the remaining southwestern utilities were operated in the fashion required by PUHCA. This important matter generated litigation at the Federal Energy Regulatory Commission, the Nuclear Regulatory Commission and the Federal Courts. Ultimately, the matter was terminated by a negotiated settlement under which all the interconnected Texas systems will be connected to the South West Power Pool through two substantial DC (direct current) interconnections and all utilities will have the opportunity to use these facilities for major power supply transactions. The ultimate goal of the DC lines is to realize the reduction of utility rates which C&SW found would result from greater coordination of its affiliates' operations with all other continguous utilities. While the remaining regulatory problems will be dealt with by FERC and the state regulatory agencies, the fact is that only the force of the Act, as administered by the SEC, was sufficient to connect Texas with the rest of the Union.

EXEMPT HOLDING COMPANIES

The continued existence of PUHCA has a profound effect upon exempt holding companies. Thus, certain exemptions of utility holding companies are not permanent and the SEC is free to revoke any such temporary exemption if the circumstances which existed at the time the exemption was granted have changed. The possibility that an exemption will be revoked acts as a deterrent to abuses by exempt holding companies and the importance of this feature of the Act is substantial when one considers that there are more than 100 exempt holding companies, each of which are indirectly regulated by the shadow of the Act.

A pending proceeding before the SEC concerning an exempt holding company's abuses illustrates the continuing importance of the Act. The Aluminum Company of America ("ALCOA") is an exempt holding company and operates two subsidiary electric utilities. The first subsidiary is denominated as Nantahala Power & Light Company ("Nantahala") while the second is called Tapoca Electric Company ("Tapoca"). In the operation and management of the two subsidiaries Alcoa has allocated all of the low cost generating resources to Tapoca to the exclusion of Nantahala. Tapoca in turn sells this low cost power on a virtually exclusive basis to Alcoa for use in its smelting plants.

Nantahala is thereby left with comparatively high cost power resources to serve its retail and wholesale customers. The wholesale customer, which is the Town of Highlands, North Carolina, the Attorney General of North Carolina and others have complained to the SEC requesting that Alcoa's exemption under the Act be revoked and that its public utility subsidiaries be operated in a fashion consistent with their public service obligations or be ordered to divest these utility companies.

The actions at the SEC were occasioned as well by the Supreme Court of North Carolina's ruling that consolidation of the two subsidiaries was required for rate-making purposes and its affirmance of a North Carolina Utility Commission determination that refunds of $18 million are due Nantahala's retail customers, owing to the allocation of high cost generation resources to the North Carolina retail customers. Nantahala has sought to oppose its retail refund obligation on the grounds that it does not separate have the funds to make good on its obligation and that payment of such refunds will compromise its ability to serve its existing customers. Of course, Nantahala is short of funds because its parent Alcoa won't provide the money or rearrange the intra-holding company agreement. In short, Nantahala is asserting that the State Commission should ignore its affiliation with Alcoa.

Nantahala's response to its state refund obligation and the continuing attempt to retain the benefits of low cost generation for Alcoa's shareholders through the manipulation of corporate shells illustrates the continued need for PUHCA. Only the Act empowers an appropriate regulatory body to see through corporate veils of this type.

This illustrates a development likely to occur in many cases in the future if the Act is repealed. ALCOA's exemption was obtained many years ago before the growth of load and the vast increase in fuel costs created critical problems. The unreviewed creation of subsidiary companies controlling public utility companies could lead to a proliferation of separate subsidiaries organized for the exclusive benefit of a few corporate interests, limited only by the ingenuity of counsel and consultants. As the ALCOA case illustrates, even effective State regulation cannot cope with holding company problems, and establishes the continued need for the Act.

Mergers and acquisitions in the corporate world, outside of regulated utilities, have become a hectic dog-eat-dog fray with a growing concentration of corporate power based upon financial leverage rather than economic justification. It has sponsored a large industry of investment advisors and underwriters, attorneys, consultants, accountants and the like who earn substantial sums from on-going corporate battles. Attached is a recent article from the Wall Street Journal recounting the activities of First Boston Corporation in participating in the "merger mania". We do not think it in the public interest that such merger mania be allowed to engulf the public utility industry. If the Act is repealed, huge profits will be made by merger operators and their advisors and brokers. Those profits will be siphoned off ultimately from the consumer, and those sums will be pocketed, irrespective of whether the resulting jerry-built corporate utility operation turns out to be economically sound and beneficial to the public utility consumer. In short the utility business is imbued with the public interest. The recent holding company abuses described herein demonstrate the continued need for PUHCA and I would strongly recommend that this needed statute be permitted to stand and continue to protect the public interest.

Moreover, the growth of the merger and acquisition movement has led to the takeover of public utilities, including exempt holding companies. Such take-overs and the resultant dangers to the public interest create the need for remedial legislation. Thus, in 1980 the Continental Group, a major multinational conglomerate, acquired Florida Gas Company. Florida Gas Company owned extensive retail gas distribution properties as well as Florida Gas Transmission Company, the sole gas transmission line in peninsula Florida, and Florida Gas Exploration Company, a gas and oil exploration and production subsidiary. The Continental Group, a large gas user, thereby obtained control of the major gas supplier to peninsula Florida (Flordia Gas Transmission). While Florida Gas Transmission is subject to regulation by the Federal Energy Regulatory Commission, the danger exists that this entity will be primarily concerned with the Continental Group's interests, as distinguished from the broad public interest.

This acquisition was accomplished without any regulatory review because the Florida Public Service Commission and the Federal Energy Regulatory Commission disclaimed any authority to review the matter.

Further, owing to the fact that Florida Gas Company sold its retail distribution properties prior to its merger with the Continental Group the groundwork was laid to avoid

SEC regulation under the Act. Such groundwork was extended by Continental's reliance on a SEC rule promulgated under PUHCA which provides that natural gas pipeline companies are not "retail gas companies", even though such entities sell large quantities of gas at retail. As a result of this Rule, Continental's acquisition of Florida Gas was exempt from the Act and no SEC scrutiny was applied to this transaction.

I would strongly suggest that Congress consider closing this loop hole in the regulatory framework and amend the Act to encompass the ownership of interstate pipeline companies generally as subjecting a holding company systems to jurisdiction under the Act.

Very truly yours,

George Spiegel

GS:mt

Mr. ROBERTS. Basically, I think the situation is that only the Public Utility Holding Company Act can be responsive to the situation created by the existence of the holding companies. The issues which caused the passage of the act in 1935 are viable issues today.

The Public Utility Holding Company Act and the Federal Power Act, as we all know, were passed as a tandem pair in 1935. The fact that they were passed, the fact that the issues prevail today as well as suggest strongly to me that the interest of the ultimate consumer is served, and requires that we still have in place and functioning, viable regulation by the Federal Energy Commission and the Securities and Exchange Commission.

It seems to me that in both of these areas, we are witnessing today a decline of vigorous Commission enforcement of statutory mandate. That, I respectfully suggest, is the direction that the Congress and the Commission should be going.

Senator D'AMATO. Thank you, Mr. Roberts.

In your prepared testimony and some of the remarks that you've made, you have indicated that it would appear that, if the act were repealed, the consumers, ratepayers, would be forced to bear the burden of some poor management decisions that go wrong.

I would have to ask, then, what are these utilities that are regulated under the Holding Company Act, that you're referring to?

Mr. ROBERTS. I am, sir, referring to utilities which are regulated under the Holding Company Act. The two utilities with which I am specifically familiar with in this context are Eastern Utilities Associates and New England Electric Systems.

Senator D'AMATO. If that is the case, aren't you really saying that in spite of the act, there is little in the way of protection from what you might term to be bad management decisions that went wrong and resulted in the problems for the area, for the utility, and ultimately for the consumer and the ratepayer?

Mr. ROBERTS. Yes. I'm suggesting that, sir.

I'm suggesting, however, that I think it's not as much a function of inadequacy of the act as it may be of inadequacy of enforcement. One of the specific references I had in mind in my prepared testimony related to a company—which I believe, unfortunately, is not represented here today, and therefore cannot present its side of the issue—it relates to Eastern Utilities and to a series of what we see as bad management judgments, which resulted in the ratepayers being required to absorb extra costs.

FERC recently entered an order which, in our judgment, reflected a complete misunderstanding of EUA's capital structure. It seems to me that the way, from the regulatory point of view, to approach that complete misunderstanding may be at least as much in SEC as in FERC.

For that reason, I cite that as an example of why this act should not be modified.

ESSENTIAL FEATURES OF THE ACT

Senator D'AMATO. What do you see as essential features of the act, as it operates today?

Mr. ROBERTS. I think the essential features of the act relate to the control over diversification, very, very definitely important today. Control over diversification, both within and without utility-related industries, I think is absolutely vital.

Quite frankly, we would not like to see, under circumstances where management judgment has not always been exercised properly, in our view—given regulation, we would not like to see regulation repealed away, so that the industry can go off into areas which they previously haven't been in before.

But, as the experience, say, perhaps with bank holding companies has shown, maybe they shouldn't be. I think that's important.

I think obviously the question of securities transactions, and transactions in general among affiliates, is extremely important, because where you don't have the arm's-length relationship—it seems to me the classic concept of regulation is that regulation substitutes for the arm's-length transaction in the marketplace.

These would be two of what I would see as very central things, Mr. Chairman.

Senator D'AMATO. So you have a very real concern about the possible effects of diversification, what the impact will be on the business community and on consumers?

Mr. ROBERTS. Yes.

Senator D'AMATO. In your statement, you describe a pending case before the Federal Energy Regulatory Commission. Your statement appears to suggest that the SEC should second-guess FERC's decisions.

Let me ask you: Does it make sense to allow—would it create an undue burden if we allowed opponents of a proposal two opportunities, in two different forums, to challenge the proposal?

Mr. ROBERTS. I think, Mr. Chairman, that was the issue which was addressed by the Congress in passing the two acts together in 1935, in my view.

In the case which is referenced on pages 3 and 4, which one of your previous questions also raised—is the fact that, as we see it, FERC, in its work in that particular case which we referenced—which is Montauk, I believe, W-4, rate base—is completely misunderstanding the capital structure.

The capital structure issues could well be within SEC jurisdiction. I don't believe it is second-guessing, given the regulatory pattern.

I believe the original congressional intent was to confer upon the FPC, then, the right to review ratemaking elements, service elements, certificating questions, things of that nature. The idea was, at the same time and concommitant therewith, to allow the SEC to be looking in its particular area of expertise, namely such things as capital structure. I think it remains a viable regulatory pattern today, sir.

Senator D'AMATO. Mr. Attorney General, I would like to thank you for taking of your time to come here to be with us this morning, and to make available your insights and to share with us your experiences and provide us with your statement. I assure you that it will be something that this committee will give great weight to.

We are concerned, and a number of people have expressed a concern, in regard to the issue of diversification that you have discussed, and that's why I was interested in getting your point of view. We thank you for your participation.

Mr. ROBERTS. I thank you for your hospitality.

Senator D'AMATO. We will have our first panel, G. J. Tankersley, chairman and chief executive officer, Consolidated Natural Gas; Guy Nichols, chairman of New England Electric Systems; and William Grigg, executive vice president, finance, Duke Power Co., Charlotte, N.C.

I'm wondering if I might request of the witnesses, so that we'll have an opportunity to ask some questions, if each witness might summarize his remarks so that there will be an opportunity for questions.

STATEMENT OF G. J. TANKERSLEY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CONSOLIDATED NATURAL GAS CO., PITTSBURGH, PA., ACCOMPANIED BY RICHARD DUNHAM, FORMER CHAIRMAN, FEDERAL POWER COMMISSION

Senator D'AMATO. Mr. Tankersley.

Mr. TANKERSLEY. Thank you, Mr. Chairman.

My name is G. J. Tankersley. I'm chairman and chief executive officer of Consolidated Natural Gas Co., headquartered in Pittsburgh.

In addition to this brief oral testimony, Mr. Chairman, I have a longer written testimony, which I would appreciate very much being incorporated in the record.

Senator D'AMATO. It will be entered into the record as if read in its entirety.

[The complete statement follows:]

UNITED STATES OF AMERICA
BEFORE THE
SUBCOMMITTEE ON SECURITIES OF THE
SENATE COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS

PREPARED STATEMENT OF G. J. TANKERSLEY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF CONSOLIDATED NATURAL GAS COMPANY

Mr. Chairman and Senators. My name is G. J. Tankersley and I am chairman and chief executive officer of Consolidated Natural Gas Company headquartered in Pittsburgh. I greatly appreciate the opportunity to appear before you today to discuss the problems experienced by Consolidated and similarly situated companies under the Public Utility Holding Company Act of 1935, and to urge adoption of S. 1871 which would provide a much needed exclusion of these companies from the 1935 Act.

I appear not only on behalf of Consolidated, but also on behalf of the other two gas utility holding companies which remain registered under the Act; namely, Columbia Gas System Service Corp. and National Fuel Gas Company headquartered in Wilmington, Delaware and Buffalo, New York, respectively. All three of us have the same problems under the 1935 Act, all of us are joined in a strong conviction that the interests of our companies necessitate prompt relief from the archaic and burdensome restrictions of the 1935 Act.

Our companies are, with minor differences, structured in similar fashion. Each has one or more subsidiaries which distribute gas at retail to residential, commercial and industrial customers and each has an interstate pipeline subsidiary which sells gas at wholesale to both affiliates and non-affiliates. In addition, each has non-utility subsidiaries including an exploration and production subsidiary.

The affairs of each of these utility subsidiaries are closely regulated by the states in which they operate. The public utility commission of each state determines the rates which may be charged customers and the level of service which must be provided, approves financings by the utilities, regulates transactions between utilities and their affiliates, and generally monitors and regulates closely the activities of the utilities within their jurisdiction. Similarly, the FERC regulates the rates, services, and inter-affiliate transactions of the pipeline subsidiaries.

Most of the gas which is distributed at retail by the utility subsidiaries of these companies is not purchased from pipeline affiliates but is purchased from independent pipeline companies, again at rates determined by FERC.

In addition to the regulatory mechanisms mentioned above, each of the three companies is subject to the Public Utility Holding Company Act. In the near half century since the enactment of the 1935 Act most gas utility companies have structured themselves in ways which permitted them to secure an exemption or exclusion from the scope of the Act, with the result that now there are only three gas holding companies subject to this additional regulatory burden (and there are only nine electric holding companies so subject). There are now over sixty gas utility holding companies which have gained exemptions from the Act.

Because we are registered under the Act, our three companies are compelled to do duplicative reporting; prevented from seeking the most favorable financing; severely constrained in undertaking new business activities; placed at a competitive disadvantage in seeking out acquisitions even within the narrow confines available to us; even restrained as to those whom we may elect as directors. In short, in addition to the intensive regulation of our activities by (in the case of Consolidated) three state regulatory commissions and FERC and the requirements of the Securities Exchange Act of 1934, we were unnecessarily burdened with another layer of regulation in the 1935 Act.

Over two years ago when I became chairman of Consolidated, I directed our officers and attorneys to commence an in-depth study of the Act to determine whether it continued to serve any significant public purpose. This decision stemmed from a growing conviction, felt not only by me but by most others in the utility industry as well, that the Act had served its purpose and was no longer necessary to provide the protections to consumers and investors which it did provide during the first couple of decades following its enactment.

For more than a year we studied the Act, analyzed the history of its enactment, considered the actions which had been taken by the Securities and Exchange Commission under it, and studied other regulatory systems which are in place. The fruit of that effort is the 120-page study which has been furnished to each of the members of this subcommittee.

This extensive study confirmed what we suspected. The 1935 Act is no longer necessary. The Act has outlived its usefulness, at least as far as gas utility holding companies are concerned, and perhaps as far as all holding companies are concerned.

I should note that our study was directed toward the impact of the Act on gas utility holding companies. We did not undertake to study it with respect to electric utility holding companies because of our relative ignorance concerning the impact on those companies. However, it is fair to say that many of our conclusions concerning the Act in relation to gas holding companies would suggest that the Act should be repealed in its entirety. Repeal, of course, would accomplish for us the same results that the amendment proposed in S. 1871 would accomplish; namely, full release from the strictures of the Act.

In considering S. 1871 and other proposals, notably S. 1977 which would repeal the Act, it seems to me that certain basic propositions should be kept in mind.

First, in recognition that laws, like people and machines, wear out, and that regulatory ones wear out quickly in a dynamic society like ours, there has been a growing conviction that laws and the agencies that administer them should periodically be subjected to a "sunset review." This notion has long antecedents. Back in the 30's, before he became a Justice of the Supreme Court, William O. Douglas suggested to President Roosevelt that agencies should be reviewed every ten years to determine whether they continued to be effective, and if they were not, then they should be abolished. It has been almost fifty years since the 1935 Act was enacted, incidentally, by the margin of a single vote in this body, the Senate. During that time it has only been modestly amended. It has never been fully reviewed by Congress. Many of the rules which continue to plague the industry were adopted early in the days of the Act when conditions were much different. And it has become a stepchild of its administrator, the SEC: presently only twenty-one of some two thousand employees of the Commission and $800,000 of its approximately $75,000,000 budget are committed to administration of the Act. If ever a statute was ripe for "sunset review," the 1935 Act is.

A second basic proposition that has grown to near-unanimous acceptance among the American people is that regulation should wherever possible be reduced unless some manifest public good, unattainable in other ways, is served by it and at a reasonable cost in relation to benefits. This involves determining whether the regulation is duplicative, timely, relevant, archaic, useless, excessively costly.

And a final basic proposition to which I believe most Americans today subscribe is that regulation is best when it is done by authorities as close to the people affected as possible. Thus, in the utility field, matters are best left to the state authorities whenever possible, since it is they who are accountable to the consumers in their state. I believe that modification or repeal of the 1935 Act provides a unique opportunity to turn back to state authorities responsibilities which in 1935 were taken from them by the federal government because, at that time, the states did not have the power or the resources to deal with the problems. Those deficiencies in the states have long since been remedied.

In considering the 1935 Act, it is helpful to dwell for a moment on its origins. During the teens and 1920's there emerged on the American economic scene a new phenomenon: the utility holding companies. These companies, which spread throughout the country, were characterized by broad geographic dispersion; extremely complex, highly leveraged financial structures; unfair contracts with affiliated supply and service companies; write-ups of assets as a basis for higher rates and higher dividend distributions; and totally inadequate disclosure to investors.

In 1927 the Federal Trade Commission undertook a study which lasted for seven years and resulted in one hundred and one massive volumes. This study confirmed the existence of the practices enumerated above and found that for a number of reasons -- constitutional limitations, inadequate grants of power by state legislatures -- the states were unable to deal with these abuses and that only federal regulation could cope with these problems.

It is noteworthy in examining this study that the focus was mostly -- in fact, almost exclusively -- on the practices of electric utility holding companies. For the most part the abuses associated with gas companies stemmed from their association with electric companies within the same systems. I do not think it is an exaggeration to say that, had the study been confined to gas companies, no federal remedial action would have been taken.

In response to this study the Congress enacted the 1935 Act. It gave to the fledgling Securities and Exchange Commission extremely broad powers to restructure the holding company industry so as to simplify it geographically and financially. The statute is a complicated one, with precise definitions, stringent requirements, and broad grants of authority to the SEC to adopt rules and enter orders. It was said at the time the Act was to be the "death knell" of public utility holding companies.

That, of course, was not precisely true, since the Act contemplated the continuation of public utility holding companies if they conformed to the requirements of the statute. In the course of the next two decades, virtually every interstate utility holding company in the country went through extensive reorganization. Some companies reorganized in ways that gained them an exemption under the Act, often subject to conditions which, if not heeded, might result in forfeiture of the exemption. A relative handful, such as those represented here, restructured in a fashion that left them subject to the strictures of the Act because of geographical and operating practicalities that precluded their exemption from the Act.

By 1955 the SEC was able to assert that it had completed the task of restructuring the public utility holding company industry. Its achievement was a noteworthy one; it involved great imagination, perseverance, flexibility and skill, and indeed, it deserves high praise. It may be said that this achievement was the foundation of the SEC's reputation as the paradigm of regulatory agencies.

After 1955 the SEC's work became considerably less dramatic. It has consisted largely of approving financings, determining whether transactions by registered companies are permissible, ruling on requests for exemptions, and processing and reviewing filings by registered companies.

While the Commission has been performing these somewhat prosaic administrative chores, the world had changed.

In 1935 relatively little progress had been made in articulating consistent, coherent bodies of accounting principles and auditing standards. The disciplinary mechanisms of the accounting profession left much to be desired. Hence, there was no effective barrier to a holding company causing a subsidiary to write-up its assets or engaging in a variety of accounting practices that are clearly impossible now. Any auditor that today gave a "clean opinion" on financial statements reflecting the practices of the 1920's would be driven out of his or her profession by state licensing authorities and by the SEC.

Furthermore, since 1935 the disclosure requirements of the Securities Act of 1933, which relate to public offerings of securities, and the Securities Exchange Act of 1934, which provides the framework for a system of continuous disclosure by publicly held companies, have been expanded and refined so that the disclosures now required of all publicly held companies are as extensive and informative as those required under the 1935 Act. For instance, publicly held companies must disclose the revenues and profits of segments of their business and a host of other information never disclosed before 1935. Were there no 1935 Act, investors would receive every bit as much information as they do now because of the operation of the other securities statutes. And, of course, the state regulatory authorities and FERC have broad powers to secure any additional information necessary for them to carry out their functions.

Another safeguard to investors, and another protection against the recurrence of the abuses that existed before 1935, has been the development of the security analysts profession, the increased sense of responsibility of the investment banking community, and the growth in importance of the rating agencies.

Any utility holding company which now engaged in pre-1935 financial practices would quickly be identified and condemned by the financial analyst community. Moreover, the rating agencies would probably refuse a rating or stamp on the company such a low rating that fund raising would be exorbitantly expensive, if possible at all. The securities of such a company would be shunned by institutional investors, which provide much of the capital to the utility industry. And no respectable underwriter would participate in the financing of an enterprise which engaged in the pre-1935 practices of utility holding companies. It is unlikely that today an Insull or one of his ilk could raise money from the public given the tight web of responsibilities that exists in the financial world.

I have mentioned that large parts of our business are regulated closely by FERC which has adopted a system of uniform accounts with which we must comply. A similar system has been adopted by virtually all state regulators, thus providing them with financial information in easily comparable form.

Perhaps of greatest importance is the changed role, activity and power of the state regulators. Since 1935 the constitutional inhibitions that prevented state regulators from dealing effectively with transactions between utilities operating in their states and affiliated companies have been eliminated. State commissions have been given broader powers. They have almost plenary power to set the rates which utilities operating in their states may charge. They have the power to examine affiliate transactions, and if they find evidence of overreaching, they can compel restructuring of the transaction or allow only a fair charge to be reflected in the rates. If they believe that the utility has not been properly capitalized, they can in effect, for ratemaking purposes, reconstruct its financing costs or prescribe an imputed capital structure and then allow in the rate only such financing costs as they conclude are appropriate. Through various means they can prevent a utility's parent from stripping out assets of the utility needed for it to provide an adequate level of service. In a number of instances, state regulators have been able to force upon enterprises wishing to reorganize as holding companies stringent conditions and restrictions on the relationship between the holding company and the utilities. Among the states which have done this are Rhode Island, Connecticut and Hawaii.

It should be borne in mind when considering this problem that less than 10% of the gas distributed at retail in this country is distributed by companies affiliated with registered gas holding companies. The remainder is distributed by companies which are not subject to the Act's authority, but which are subject only, in their retail activities, to the state authorities. We hear no cry from the states that they are not able to handle this responsibility and that they need a broader federal involvement. The proof of the pudding that the states can effectively regulate the activities of utilities is seen in their sole regulation of over ninety percent of the gas distributed at retail in this country. On this point I strongly urge that you give particular attention to the filed testimony of Mr. Luther Heckman, former chairman of the Public Utility Commission of Ohio, and Mr. Richard Dunham, former chairman of the Federal Power Commission, who spell out how they were able to fully protect the ratepayers without relying on the 1935 Act.

Thus, without the 1935 Act regulating the gas utility holding companies, the necessary protections of consumers and investors would continue. The consumers would be protected by the state regulators, who, after all, are closest to the scene and more conversant with the needs of consumers. The investors in such holding companies would be protected in the same fashion in which investors in other enterprises (including exempt utility holding companies and publicly held utilities not parts of holding company complexes) are protected, through the demands of the 1933 and 1934 Acts, the integrity of the accounting profession, and the professionalism of financial analysts, investment bankers and rating agencies.

While there has been in very recent times some modest amelioration of the strictness of the application of the 1935 Act to holding companies, still the restraints that were imposed by the Act and rules adopted in its early stages continue to impact registered holding companies in obsolete and unfair ways. Let me ennumerate some of them.

Let me say first that the questions of unnecessary regulation under the 1935 Act and diversification by holding companies often become interwined to such an extent that some consider them as one and assume that the effort to secure repeal of, or exclusion from, the 1935 Act has its origins solely in a desire to engage in wide-scale, non-energy related diversification. While diversification is a consideration which I will discuss shortly, it is by no means the sole origin, or even the main origin, of the desire of our companies to secure exclusion from the 1935 Act. Rather, the origin is the entire network of restraints in the Act which unfairly and unreasonably inhibits the freedom of the management of these companies.

Even for a "functionally related" acquisition which a registered holding company may make, there is the need for prior approval by the Commission before the transaction may be embarked upon. In an economy in which deals are often done with lightning speed, the would-be acquirer that must secure a regulator's approval will be at a severe disadvantage vis a vis a competitive bidder not so restrained.

A recent experience we had at Consolidated well illustrates this problem. Our gas exploration program requires that new prospects for gas drilling programs be added continuously. We found a small oil and gas company in Texas with attractive acreage and reached a tentative agreement to acquire its interests for $7,600,000. However, before we could consummate this transaction, we were required under the 1935 Act to, in effect, publicly advertise our agreement, including all its details, in the Federal Register, thus alerting other would-be purchasers to what we were doing. In this fast moving world you simply cannot do business that way.

All financings by both the holding company and its subsidiaries must be approved by the SEC, even though those of the subsidiaries, including those with the parent, must also be approved by state authorities. In effect, the Commission sits as a member of the finance committee of every registered holding company. Moreover, under a rule that was adopted in 1941 when there was a surge of interest in competitive bidding in connection with all corporate financings, all equity and public debt financings by registered companies must be in accordance with competitive bidding procedures. This results in delays and complications that prevent the precise targeting of offerings in today's volatile markets. The dual requirements of advance notice and approval of financing plans by the SEC and the competitive bidding procedures prevent the agility and adaptability that make it possible to move when a "window" conducive to public offerings appears, thus creating the strong likelihood that registered companies' capital costs will be more than they would be otherwise. Virtually all other public corporate financing in this country is done through negotiations between underwriters and issuers; the universality of this practice is clear evidence that issuers find it a superior means of raising capital.

Furthermore, the universe from which registered companies can recruit directors is severely limited. It is axiomatic today, when there is unrelenting pressure for publicly held companies to expand the number of unaffiliated directors on their boards, that it is increasingly difficult to find good, competent people and persuade them to come on boards. Again, as a consequence of a statutory provision and a rule that had their origins in a time when there had been unhealthy alliances between holding companies and the financial world, a registered holding company cannot have on its board anyone who is the director of any bank of more than minimal size located outside its geographical area of activity. Thus, no matter how well qualified, anyone who is, say, on the board of the Bank of America, or Chase Manhattan, or Continental Illinois, or any other significant bank outside the area within which we operate, is barred from serving on the board of our company. As a consequence, a very large number of America's top business men and women are barred from our board. Also, less than half of a registered company's directors are permitted to have "financial connections," i.e., be bank directors, thus further limiting the choice. Registered holding companies should have the same latitude in recruiting people of competence to serve on their boards as other companies, including utility holding companies exempt under the 1935 Act and utilities in general.

Notwithstanding some evidence of a more relaxed attitude at the Commission with respect to registered holding companies entering into joint ventures, there continues to be considerable uncertainty whether the presence of a registered company in a joint venture makes the venture itself subject to the Act -- a consequence that inhibits the participation of a non-registered company in a joint venture. Thus, this small group of companies is hampered in the use of their resources in this type of venture which serves an increasingly important role in the development of resources in this country. To have the danger of 1935 Act regulation hover on the horizon if a registered company participates obviously chills interest in involving such a pariah in a joint venture.

A considerable duplication of reporting is imposed by the Act. Virtually all of the same information that must be submitted to the Commission is already submitted to state regulators and FERC and made available to the public under the 1934 Act. While such duplication could once have been loftily dismissed as "just paperwork," we know now the heavy cost that "just paperwork" imposes on American industry.

Finally, the 1935 Act and the Commission's administration of it have unfairly and unwisely hampered the opportunities for registered companies to make maximum use of their financial, managerial and other resources.

As mentioned, the test of whether an acquisition is permissible is whether the business to be acquired is "functionally related" to the utility operations of the company.

This standard is in sharp contrast to that applied in determining whether an exempt holding company has forfeited its exemption by one or more acquisitions. There the standard is whether the new business would be "detrimental to the public interest or the interest of investors or consumers." In the few cases in which the Commission has considered the diversification acquisitions of exempt companies, it has permitted them to engage in a wide range of activities, including real estate development.

This disparity in policy governing exempt holding companies and registered companies is dramatic, and plainly places the registered companies at a severe disadvantage in efforts to diversify risks. A high Commission official has been quoted as having stated that the Commission policy is not to interefere with diversification activities of exempt holding companies as long as the non-utility operations do not impair the utilities.

An example will demonstrate the narrow interpretation the Commission has given the "functionally related" standard. In 1970 the Commission refused to permit Michigan Consolidated Gas Co., a subsidiary of a registered holding company, to make a modest investment in a low and moderate income inner-city housing project in Detroit, which was within its marketing area, on the grounds that such was not "functionally related" to its utility activities. Contrast this denial with the remarkably successful work of Brooklyn Union Gas Company, which is not subject to the 1935 Act, in the "Cinderella" project to upgrade housing in its service territory. Simply put: why is it good for Brooklyn Gas to do this, while it is bad for Michigan Consolidated? The answer is simple: one is subject to the archaic, outmoded restrictions of the 1935 Act, the other is not.

As a consequence of this stringent attitude on the part of the Commission, registered holding companies are unable to compete on even terms with other enterprises, including exempt holding companies, in acquiring desirable enterprises. Even when a registered company has some belief that its proposed acquisition might pass muster with the Commission, the necessity of filing, notice, and Commission action precludes the sort of quick decisionmaking which is essential to accomplish acquisitions successfully. Any seller, confronted with the delays and uncertainties of dealing with a registered company, is obviously going to find it more comfortable and expeditious to deal with a buyer not hampered by such procedural demands and uncertainties. There is also, of course, the problem previously mentioned of having to make public the terms of the transaction in advance.

The anomalies resulting from the 1935 Act abound. If a registered holding company undertakes research and development which leads it into a practicable possible venture that is not functionally related to its utility business, it cannot reap the full benefits of the project. Similarly, a registered gas holding company can purchase coal reserves for the purpose of gasifying the coal for use in its system, but not for the primary purpose of mining and selling the coal, no matter how advantageous that might be to its stockholders.

These limits on diversification and expansion into other enterprises are particularly troublesome for the three gas holding companies. These companies have achieved an extremely high degree of "saturation" of the residential markets in their areas, that is, there is little opportunity for expansion of service to existing homes. The populations of these markets are relatively static, hence there is little likelihood of expanding the use of gas because of community growth. Compounding this problem is the remarkable success of conservation efforts (strongly encouraged by the gas companies, incidentally) among residential -- as well as commercial and industrial -- gas users. Since 1973 the average residential and commercial use of gas has been reduced by over twenty percent and the trend is continuing.

The problem is further compounded by the fact that long term outlook for industrial use of gas in our marketing areas is static at best.

Moreover, there is the likelihood of intensified competition from other fuels. Already in some places the cost of gas per million Btus is approaching that of No. 6 oil, and as the price of gas increases under the market pricing mechansims of the Natural Gas Policy Act, the price advantage which gas has heretofore enjoyed may be further eroded. Moreover, as technology develops increasingly efficient electric heat pumps, electric heating is becoming more competitive.

And finally, the product of the gas industry -- energy -- comes from a single exhaustible source -- gas. Although the present outlook for gas supplies is considerably brighter than it was five years ago, nonetheless there is still considerable uncertainty about the long-term supply availability of it at competitive prices. Electric utilities, of course, can provide their service using nuclear power, gas, oil, coal, shale, and hydroelectric means.

For all these reasons it is imperative that the gas holding companies have greater latitude in diversifying their activities. I would assure you that it is not our intent to seek out high-risk enterprises far removed from the fields with which we are familiar. The limits of our ambition are energy-related enterprises, which while perhaps not "functionally related" to what we are now doing, nonetheless would be relevant to the nation's efforts to expand the availability and uses of energy and would be squarely within our managerial experience and competence. Moreover, any business which we may get into will not be chosen haphazardly or without a great deal of thought and advance planning, including exhaustive financial studies to make it as certain as is possible that the new business will be successful. Consolidated has carefully developed a set of criteria which any new business proposal must meet, including a return on equity well above that which we are allowed in our regulated businesses.

Is it likely, or even possible, that such diversifications into non-utility, albeit energy-related, fields would adversely impact the ratepayers? All of the evidence available now would suggest that the possibility of such an impact is remote at best. As discussed earlier, the state regulatory authorities have broad power to set rates. If they determine that a diversification has resulted in higher costs of capital, they can reflect in the rates what the cost of capital would have been if the utility had raised it "standing alone" and can even impute a different capital structure; they can prevent the withdrawal of assets from the utility if it would hamper effective service by the utility; they can review associate transactions and permit to be reflected in rates only fair pricing of services and supplies. They can, in short, isolate the utility effectively from the impacts of diversification. There is no evidence that, notwithstanding the extensive diversification over the years of utilities and holding companies not subject to the Act, the states have not been able to deal effectively with the impact of diversification on utility operations. It is worth noting in passing that the troubles that have affected utilities, e.g., Consolidated Edison, General Public Utilities (Three Mile Island) and others, have been the result of problems in their utility operations and have in no way stemmed from diversification. One would be hard put to find any instance in which diversification by a utility or a holding company has adversely affected ratepayers. Our search has found none. There is no reason to think the result will be different if the three registered gas utility holding companies are released from the 1935 Act.

There is in all this a simple question of fairness and equity. Utilities and utility holding companies not subject to the Act and many utilities have broad latitude to diversify and to insulate their investors against undue dependence upon a single activity. This opportunity has not been abused and it has not harmed the ratepayer. There is no reason to deny the registered gas utility holding companies the freedoms and opportunities accorded others who are engaged in the same businesses and perform the same economic functions.

A final question must be answered: If S. 1871 is enacted and gas utility holding companies are excluded from the 1935 Act, will the pre-1935 Act abuses recur?

I can say with confidence, and resoundingly, no.

In the first place, the accounting and financing practices that prevailed in the 1920s would be impossible today because of the maturing of accounting principles and auditing practices, the enhanced integrity and standards of the investment banking community, the vigilance of financial analysts and the demands of the rating agencies.

Second, the Securities Act of 1933 and the Securities Exchange Act of 1934 assure that an abundance of information concerning the companies will be available to investors and regulators alike and that any improprieties will be quickly identified and publicized.

Third, the increased presence of non-affiliated directors on the boards of all companies, including gas utility holding companies, who are increasingly aware of their obligations to the public and sensitive to the dangers of litigation in the event of inadequate vigilance, provide an additional level of assurance that managements could not indulge in the pre-1935 Act practices.

Fourth, the ability of the state regulators (and it was their inability to control the conduct of the holding companies which mainly prompted Congressional action) is enormously enhanced since 1935. The state laws are tougher and more comprehensive, and the state regulators have learned how to use their powers effectively. Moreover, the constitutional barriers to the exercise of their power have fallen, thus freeing them to deal more effectively with utilities and their affiliates.

And finally, with the fate of utilities which abuse their position writ large in the history of the last half century, it is most unlikely that any management would again attempt the sort of abuses which were widespread in the 20s. They could not get away with it. And they know it.

Mr. Chairman and Senators, the time is clearly here to free these three registered gas utility holding companies from the archaic and unnecessary burdens of the 1935 Act. It is high time to free them from the necessity of duplicative filings; to free them of the unfair and ridiculous limitations on their ability to seek the strongest possible boards; to free them from obsolete restrictions on the expansion of their businesses, restrictions that are not imposed upon other businesses doing substantially the same thing; to free them from the necessity of running to a regulatory agency of the federal government for advance approval of financings; to free them from the need imposed upon only a handful of enterprises in this country to submit their financing proposals to competitive bidding. In a word, it is high time to free these businesses from burdens and restraints that no longer make any sense and from an Act that hampers severely the most efficient use of their resources of capital and management.

The three companies for which I speak urge earnestly that you act favorably on S. 1871. Its enactment will be a significant step in restoring fairness to the market place and in assuring the continued health of this vital industry.

Thank you.

Senator D'AMATO. Thank you very much.

Mr. TANKERSLEY. We do appreciate the opportunity to discuss the difficulties that we face in operating a large, natural gas system subject to the Public Utility Holding Company Act of 1935 and, in particular, to discuss Senate bill 1871, which would provide a much-needed exclusion of gas utility holding companies from the act.

In my testimony today, I want to show you a clear picture of a counterproductive law—one that unfairly limits the conduct of a vital business, and yet offers no protection to either consumers or investors that they don't now receive from other laws or regulatory bodies.

RELIEF FROM ARCHAIC RESTRICTIONS

I appear not only for Consolidated, but also on behalf of the only other two gas companies still registered under the 1935 act. They are the Columbia Gas System, headquartered in Wilmington, Del., and National Fuel Gas Company of Buffalo, N.Y. All three of us share a strong conviction that prompt relief from the archaic and burdensome restrictions of this legislation has now become necessary.

This act does not provide any benefit to the public not already available in some other form. And those opposed to repeal or modification of the act cannot point to any logical, harmful scenario that will result from repeal or modification. Yet the act severely restricts the abilities of our three gas systems to respond adequately to changing business and economic conditions.

It prevents us from using the resources of the Nation's Capital markets with maximum flexibility and at minimum cost.

It limits our ability to diversify where appropriate. I'll discuss our viewpoint on diversification in just a moment.

It denies us opportunities that are routinely accorded others who are in the same businesses and perform the same economic functions as we do, including 60 exempt gas utility holding companies.

Consolidated, National Fuel, and Columbia are three of the oldest and largest natural gas systems in the country. In the States we serve—which are New York, Ohio, Pennsylvania, West Virginia, Virginia, Maryland, and Kentucky—is some 25 percent of the Nation's industrial capacity.

At a time when everyone is worrying about the ability of the Nation to revitalize its basic industries, there is a clear need to insure that these three vital utility systems do not become latter-day business dinosaurs, unable to adapt to change because of outmoded legislation five decades old.

A strong conviction that the 1935 act discriminates against us led me 2 years ago to direct Consolidated's officers and attorneys to review the act in depth. They did so thoroughly, analyzing its history and administration and the impact of parallel regulation. The fruit of that effort is the 120-page study previously furnished to each member of this subcommittee.

In considering S. 1871 and the other proposals before this committee, it seems to me that three basic philosophical propositions should be kept in mind.

The first is that laws and regulations, like people and machines, wear out. There is a well-founded, logical and growing conviction that laws and the agencies that administer them should periodically be subjected to a sunset review. If ever a statute was ripe for sunset review, the 1935 act is. Incidentally, I might note in passing that the act was adopted in the Senate by a single-vote margin.

The second basic proposition—one that has achieved near-unanimous acceptance among the American people in recent years—is that regulation should wherever possible be reduced or eliminated unless it serves some manifest public good at reasonable cost. This involves determining whether a regulation is effective, timely, and relevant, or duplicative, archaic, and excessively costly. And the 1935 act, we believe, is the latter.

A third proposition to which most Americans subscribe today is that regulation is best when it is done as close as possible to the people affected. In 1935, most States did not have the power or the resources to deal with the problems the act addressed. But, clearly, those deficiencies at the State level have long since been remedied.

These are three broad concerns, but they are very important ones to consider. We've documented our position in our 120-page study and set it out in detail in my filed testimony. Our attorneys, who include a former SEC Commissioner, and the CEO's managing the three gas companies are convinced this act performs no valid functions today.

Since your time is restricted today, let me highlight the main points made in our study and in my filed testimony.

STUDY HIGHLIGHTS

First, the act does not any longer, by itself, insure the flow of information to investors. If the 1935 act is repealed, investors will still receive every bit as much information as they do now because of the Securities Act of 1933 and the Securities Exchange Act of 1934.

Nor does the act offer any unique protection to consumers. State commissions can—and do—examine transactions between affiliated companies, and if they find evidence of overreaching, they can force restructuring of the transaction or permit only what they deem a fair charge to be reflected in rates. If they object to the way a utility is capitalized, they can allow only such financing charges as they conclude are appropriate to be recovered in the rates.

It should be borne in mind that less than 10 percent of the gas distributed at retail in this country is distributed by companies affiliated with registered holding companies. The rest is distributed by companies subject only to State authorities who have, over the years, demonstrated beyond any question that they can handle this responsibility and handle it well.

On this point, I strongly urge that you give particular attention to the filed testimony of Luther Heckman, a former chairman of the Public Utilities Commission of Ohio, and of Richard Dunham, a former chairman of the Federal Power Commission, who spell out how they were able to fully protect the ratepayer without relying on the 1935 act.

Indeed, Mr. Chairman, Mr. Dunham is here at the table with me and will be able to answer questions on this important point.

Although there has been some modest amelioration of the strictness of the application of the 1935 act in recent years, it still impacts registered holding companies in obsolete and discriminatory ways.

The act places sharp restrictions on financing, and there's good reason to believe it makes financing more expensive than it might otherwise be. All our financing must be done by competitive bidding. Virtually all other public corporate financing in this country is done through private placements or through negotiated offerings between underwriters and issuers—clear evidence that issuers find these methods superior. Nevertheless, we continue to be restricted to cumbersome procedures which prevent the precise targeting of offerings in today's volatile and sometimes chaotic markets.

Because of the strictures of the 1933 act, a registered holding company can't have on its board of directors any person who is the director of a bank or anything more than minimal size if that bank is outside the utility companies' geographical area of activity. Even more ridiculous in this day of emphasis on directors' responsibilities is the fact that under the act we have to be sure that fewer than half of our members serve on any bank board at all. That eliminates as possible candidates for our boards a large percentage of the best businessmen and women in America.

There is duplication of reporting. Virtually all the information we submit to the SEC under the 1935 act is already submitted to state regulators and to FERC and is made available to the public under the 1934 act.

Finally, the act puts onerous restrictions on us as we attempt to keep our businesses up to date by adding to them or diversifying them. We have no plans to diversify into high-risk areas far removed from the fields with which we are familiar. But there are many energy-related enterprises, which while perhaps not functionally related to what we are now doing, nonetheless would be relevant to the maintenance of our strength and flexibility in a deteriorating sales market.

Even when we plan expansion into a business that meets all tests under the act, the act requires us to make public all elements of a proposed acquisition a minimum of 25 days before consummation. This requirement obviously can allow a competing bidder the time and information he needs to better our deal with the seller.

The act creates other problems. For example, if a registered holding company discovers a new business opportunity in the pursuit of its reasearch work, it cannot reap the full benefits of that research if the business the research leads to is not functionally related.

You may be interested to know, too, that the burden of regulation under this act has led to some glaring inconsistencies among companies. Some years back, a subsidiary of a then-regulated holding company was denied the opportunity to invest in an inner-city, low-income housing project in its utility service area in Detroit because the investment was deemed to be not functionally related.

Contrast this denial with the remarkably successful work the Brooklyn Union Gas Co.—which is not subject to the act—has done with its Cinderella project, which upgrades housing in Brooklyn.

Why is it good for a utility to be involved in upgrading housing in Brooklyn but not in Detroit? The answer is simple: One is subject to the archaic restrictions of the 1935 act, the other is not.

This disparity is as unfair as it is dramatic. Exempt companies have been permitted to engage in a much wider range of activities than registered companies.

In summary, in new business activities and in existing ones, registered holding companies cannot compete on an equal footing with other enterprises. We can't move as fast. And we can't move as far.

Clearly, a change in the Utility Holding Company Act is in order. We know our markets are going to change. We know the country's energy situation is going to change. Capital markets will change, and technology will change.

We need a fair opportunity, Mr. Chairman, to change, too.

Thank you.

Senator D'AMATO. Thank you Mr. Tankersley. Mr. Nichols?

STATEMENT OF GUY W. NICHOLS, CHAIRMAN, NEW ENGLAND ELECTRIC SYSTEMS, WESTBOROUGH, MASS.

Mr. NICHOLS. Thank you, Mr. Chairman. I'm chairman of New England Electric Systems, one of the nine registered electric holding companies regulated by the 1935 act.

Together with eight of those registered electric companies I have been working to review the need for this act, and I share the position that is taken by our industry that urges you to consider repeal of the act.

Thinking about your instructions to this panel this morning, I think it perhaps might be more helpful if rather than review my written testimony, which is very consistent with Mr. Tankersley's, it might be more important and more helpful if I attempted to review some of the questions that you and members of your committee have raised over the past 2 days of hearings.

We have put together a list of those questions and provided that list to you and your staff.

Senator D'AMATO. Quite adequately, I might add.

Mr. NICHOLS. Thank you. They were interesting questions and we're prepared to address any one of them, but perhaps there are two areas of specific interest that surface: One concerns investor protection and the other concerns ratepayer protection.

For example, the question which heads the list for the hearings on April 27 deals with what protective provisions with respect to securities issuances under the act continue to be necessary to protect utility investments.

PROTECTING INVESTOR INTEREST

Frankly, Mr. Chairman, I think the answer is simply none because under the Holding Company Act there are three avenues available to protect investor interest and they, as Mr. Tankersley suggested, are adequately covered elsewhere.

Those three are the authority to require public reporting of the system's financing, capital structure and related matters, the authority to require that these reports comply with uniform accounting standards, and the authority to control the substance of securities issues including redemptive provisions, provisions and the like.

Now, the first two categories requiring reporting requirements and accounting standards are unnecessary in today's world because they've been duplicated by the Federal Securities laws which apply to all publicly-traded corporations and also by professional accounting standards.

The third category of controls, although not duplicated elsewhere, is nevertheless also unnecessary because marketplace disciplines imposed by informed investors in today's very sophisticated market are fully adequate to deal with these matters.

I think the inescapable point is that investor protections afforded under the modern administration of the securities laws coupled with the development of professional accounting standards and regulation of trading markets have eclipsed the investor protection sought to be achieved under the 1935 act.

I think we must keep continually in mind the fact that exempt holding companies are not similarly subjected to the specialized controls nor are nonholding company utilities. They must comply only with the 1933 act and the 1934 act and either State commission or Federal Energy Regulatory Commission controls on public utility companies.

It cannot be seriously claimed that investors in these companies are exposed to greater risks than investors in our companies.

The other area of interest that was raised by your questions concerned the interest of the rate payers. Question No. 3 drawn from the hearing on June 8 asks: Do States have adequate authority, personnel and resources to assume responsibility to perform the regulatory functions now fulfilled by the SEC?

I gather from this question and a number of other questions of similar thrust that the subcommittee quite understandably seeks assurance that rate regulatory authorities are adequate to protect rate payers' interests.

In 1935 Congress I think properly had little faith in State ratemaking abilities because at that time only 22 States regulated electric rates and at that time of course there was no Federal regulation of electric rates.

But today, as in the case of securities regulations, things have certainly changed. Our previous speaker this morning, a very capable attorney general from the State of Rhode Island and his staff together with an excellent State commission chaired by a man who is now also chairman of the National Association of Regulatory Utility Commissioners, is typical of sophisticated staffs that very, very well represent ratepayers' interests.

I think, in general, both FERC and the State commissions are perfectly capable of protecting consumers against excessive rates or unreasonable costs.

Now we have not attempted to review the State laws in all 50 States, so I can't assure you that in every case rate authorities are ready to fill any gap left by repeal—if there is a gap. And I question it—but if there is a gap it's a gap that exists today with respect to 80 percent of our industry. And perhaps more important is that any deficiency in the scope of State authority is statutory, not constitutional. If regulatory deficiencies are discovered, the State legislatures are fully empowered to rectify them.

I can personally attest to the adequacy of FERC regulatory powers under a series of very fine Chairmen as well as those of the States involved in the regulation of our own system's operating companies—three States in New England.

Now, the claim has been raised before this committee that these arguments, however persuasive with respect to single State utilities, do not apply with respect to utility systems whose operations extend into several States.

The primary concern here, it appears, is that a diversified utility can perhaps frustrate effective State regulation by keeping its nonutility business out of State and therefore outside the reach of State regulators.

Perhaps when the act was passed the interstate nature of utility holding systems could defeat then effective rate regulation, but that's not the case today.

JUDICIAL OPINION SUPPORTS REGULATORS

Today judicial opinion supports the authority of State regulators to gain access to any information necessary to perform their essential ratemaking functions.

Some States have already passed affiliate transaction statutes that expressly assert this authority. Others simply exercise that authority as part of their ratemaking functions.

In any case, the registered companies have consistently demonstrated their willingness to provide the information necessary to justify their costs, as they should do. And it is just plain common good business judgment that an electric utility holding company will always provide the information essential to a State ruling on the rates of any one of its operating companies.

If it failed to do so, it would risk the displeasure of that commission; and believe me, that is a risk that you don't take lightly. The scope of the authority over the utility company's ratemaking does not change simply because the utility does business with an out-of-State affiliate.

One other point I'd like to make in this area: I believe that the holding company corporate structure makes it easier for State commissions to properly regulate the rates of utility companies, because the holding company structure permits you to set up easily individual subsidiaries for diversified activities. Individual subsidiaries are by far the easiest way to assure that proper accounting controls will be used and costs will be isolated to those individual subsidiaries.

I think the holding company form of structure should be encouraged, not discouraged, as is now the case.

In conclusion, Mr. Chairman, I think the case for repeal of the act is a very strong one, and I would particularly ask you to give particular weight to the view of the Securities and Exchange Commission itself, as it is their unanimous view that this act has served its basic purpose and that continued Federal regulation of holding companies is no longer necessary or appropriate. And if your committee is inclined to leave this 47-year-old statute on the books, and

I hope you will not, but if you should elect to do so, I would respectfully request that you clearly articulate the public policy reasons for doing so, because the shareholders, the operating companies, ratepayers and the American taxpayers themselves all bear the costs associated with this act. And there are costs. I believe that that group does have the collective right to know exactly what benefits justify the continued maintenance of this outmoded regulatory scheme.

From my perspective, I cannot see any. Indeed, I can see only unnecessary and costly hindrance to the pursuit of what I believe are legitimate management interests.

Mr. Chairman, I'll be glad to respond to any of the other questions on this, if you would like them.

[The complete statement follows:]

Statement of

Guy W. Nichols
Chairman, President and Chief Executive Officer
of New England Electric System

on behalf of

The Registered Electric Utility
Holding Company Group

Mr. Chairman, Members of the Subcommittee, I appreciate the opportunity to appear before you today, as the Subcommittee continues its consideration of legislation to repeal or amend the Public Utility Holding Company Act of 1935. I am Guy W. Nichols, Chairman, President and Chief Executive Officer of the New England Electric System (NEES). NEES is an electric utility holding company system whose subsidiaries provide electricity to communities in Massachusetts, Rhode Island and a small portion of New Hampshire. NEES is also one of nine registered electric utility holding company systems directly regulated by the Securities and Exchange Commission (SEC) under the Holding Company Act.

I am appearing today on behalf of a group composed of seven of the nine registered electric utility holding companies,1/ who have associated in an effort to seek Congressional reconsideration of the continuing validity of the Holding Company Act. As the Committee's hearing record already shows, neither government nor industry continues to operate under the circumstances which in 1935 compelled Congress to subject electric and gas utility holding companies to the New Deal's most comprehensive scheme of regulatory controls. After almost five decades, it is time for Congress to re-examine this

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1/ The other companies are Central & South West Corp., the American Electric Power Co., Eastern Utilities Associates, Middle South Utilities, Inc., Northeast Utilities and the Southern Co. An eighth system, General Public Utilities, Inc. supports our purposes to eliminate unnecessary and burdensome regulation.

Act to determine whether its provisions continue to accomplish a valid public purpose.

The 47-year history of the Act has been paralleled by the evolution of other expansive and sophisticated mechanisms of utility regulation. Today the companies in registered systems such as NEES conduct their corporate affairs within the overlapping perimeters of three basic regulatory schemes: state and federal regulation of the rates we may charge for utility service; regulation under federal securities laws of our access to the securities markets (which is among the most vital aspects of doing business in the capital intensive electric utility industry); and comprehensive SEC supervision of all our basic corporate decisions under the Holding Company Act. The development of rate and securities regulation has, we believe, overtaken the usefulness of Holding Company Act regulation. And, as the SEC has recommended, the Congress may now safely remove the elaborate controls on holding company activities. Most of Act's controls no longer serve a valid purpose. Those that remain valid would appear to be largely duplicated by or more appropriately accomplished through other existing state and federal regulatory means.

I would like to associate myself with the testimony presented by Floyd W. Lewis, Chief Executive Officer and President of Middle South Utilities, who appeared before the Subcommittee last month representing the views of the Edison Electric Institute in support of repeal. I have examined the record of the April 27 hearing and have attempted to cull from that record the issues which Chairman D'Amato has identified as material to the Subcommittee's re-examination of the public policy foundations of the Holding Company Act. These issues, quite properly, embrace an array of concerns -- from the effects of diversification on utility rates and service to the adequacy of securities and rate regulation in preventing recurrence of past abuses. I have therefore structured my testimony to draw from the experience of regulated companies specific responses to the questions raised at the earlier hearings.

Before I begin the task of addressing these issues, some preliminary comments are in order. This is not a case where the Congress is being asked to step in and restore reason to a regulatory agency which misperceives its public responsibilities. The SEC and its staff have done a highly commendable job in administering this statute. Their efforts deserve praise (an uncommon circumstance in these days of growing dissatisfaction with the work of government.) This agency has over the years earned the public's respect for professional competence and integrity. My comments today, though sometimes critical, should not detract in any way from the deserved high reputation of this Commission and its staff.

I would like now to proceed by examining the Act's original purposes against the experience of companies that have charted their corporate course through the channels of SEC regulation. Although the Act's regulatory controls are many, its original purposes were three:

- first, to simplify the then-existing holding company systems;
- second, to protect investors from abusive financial practices; and
- third, to protect utility customers from excessive charges tied to intercorporate dealings, and other unreasonable costs.

Simplification of Holding Company Systems

The reorganization of the then-existing holding company systems was the chief objective of the Act. Because this task was accomplished almost three decades ago, the Subcommittee is probably least familiar with this aspect of SEC regulation. But in the 30's and 40's this was one of the SEC's most prominent and well recognized functions. While I do not intend to recapture for the Committee a full and thorough history of the Act, it is useful to note briefly the circumstances of the industry which led Congress to wield so heavy a club as divestiture against utility holding companies of the past.

At the time of the Act's passage, a large portion of the nation's electric and gas utility industries had come under the common ownership or control of a small number of holding companies. These holding companies bore little resemblance to the utility holding company systems of today, which are organized to coordinate the affairs of a relatively small number of local utilities and diversified businesses under the managerial umbrella of a single holding company. The systems of the past were not designed to the ends of managerial efficiency. Rather they were, in effect, investment pyramids. Their structural intricacies obscured what by today's standards would be wholly untenable financing practices such as "stock watering," overstatement of assets and the like.

Congress concluded that the remedy to these abuses exceeded both the reach of the newly enacted federal securities laws and the then quite limited scope of state regulatory authority. Congress therefore mandated that these systems be broken up and their capital structures simplified.

Essential to the SEC's task of reorganizing these systems was determining which companies could be retained as part of a "geographically and economically integrated utility system" as section 11 of the Act requires. Reorganization was pursued, and divestiture ordered, primarily to eliminate the concentrated ownership of geographically dispersed utility companies.2/ As a result the investor-owned electric utility

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2/ General Accounting Office, the Securities and Exchange Commission's Regulation of Public Utility Holding Companies: An Evaluation of Commission Comments on a Critical Report (Jan. 4, 1978) (Appendix II, Comments of the Securities and Exchange Commission on the Comptroller General's Report of June 20, 1977, to the Congress in the Administration of the Public Utility Holding Company Act of 1935).

industry is now comprised of many independent local operating companies, a large number of exempt holding companies and nine fully regulated holding company systems.

With the industry now structured in a manner consonant with the Act's purposes, the SEC's current supervision of holding company investments has little to do with policing deviations from the principles of geographic and economic integration of the utility business. Today, the SEC's decisions as to which businesses a company may acquire or retain primarily relate to what "other business interests" are deemed to be "functionally related" to the electric utility business.

The primary effect of the "functional relationship test" is to confine the universe of business lines a company may pursue to those which are related to the utility business, such as fuel supply and associated transportation. Over the years, the SEC has enjoyed a broad sweep of discretion in determining what ventures meet this test. In recent years the SEC has tended toward a more expansive application of the test, permitting companies to enter lines of business which under prior interpretations would not likely qualify as functionally related. For example, the NEES system gained approval in 1981 for its fuel subsidiary to enter the coal transportation business in a joint venture with Keystone Shipping to build and operate a coal-fired coal transport ship to bring coal to NEES' generating company subsidiary, New England Power Co. (NEP). And, the Southern Co. is now authorized to market utility management services to other non-affiliates. However, in contrast to these examples are other comparable circumstances which, in the SEC's view, do not meet the test. For example Middle South Utilities, which is permitted to operate oil barges to transport fuel to its generating facilities, was denied authority to enter long-term contracts to hire out those barges to back-haul fuel for other utilities.

While the universe of functionally related businesses may expand, it expands slowly, and only when an individual company approaches the SEC on an ad hoc basis for approval of the specific terms of a particular venture. In part this is because, in addition to meeting the "functional relationship" test, we must persuade the SEC to approve the specific terms of all the financing arrangements and contractual provisions which underlie any business venture. Thus, even activities that are obviously and historically recognized as functionally related, such as acquisitions of coal reserves, can be delayed for three to six months or longer, until the details of associate company purchase contracts are approved by the SEC.3/

3/ In some cases, through substantial negotiations with the staff, flexibility can be secured. For example, NEES is engaged in an oil and gas exploration and development partnership through a subsidiary, New England Energy, Inc. (NEEI). NEEI is permitted to invest in the partnership for acquisition of its share of new leases under the terms of a budget worked out annually with the SEC. However, each year

[footnote continued next page]

It should also be understood that any elasticity in the administration of the "functional relationship" test is subject to a troublesome counterweight: the SEC's continuing jurisdiction to order the divestiture of diversified businesses "in the public interest" or "in the interest of investors or consumers." As I've stated, the Commission historically has exercised this authority to accomplish the physical integration of utility systems and the elimination of non-functionally related holdings. However, there is no apparent barrier to the SEC's use of this authority to reverse its approval of a diversified investment for any other reason, so long as it can be justified "in the public interest."

Shaping a diversification strategy that fits the bounds of these regulatory constraints exacts a toll in opportunities lost to regulatory delays and affirmative prohibitions on certain types of ventures. The registered systems know of many examples and I will attempt to provide the Committee with some of these later in my testimony.

Concern with lost diversified business opportunities presumes that sound public policy should permit utility

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NEEI faces the prospect that the SEC will not approve investment at the levels demanded by NEEI's partner. And, even with the budget authorization in place NEEI could not respond quickly to purchase attractive properties if the annual budget limits would be exceeded.

management the discretion to diversify. I would therefore like to turn now to the issue of diversification and provide the Committee with an understanding of its benefits from the perspective of a registered utility system manager.[4]

At the April 27 hearings the Subcommittee's Chairman specifically asked that the industry elucidate the point that diversification can lower a utility's cost of capital. Therefore in discussing the potential benefits of diversification I will proceed from that point. This issue has been addressed most recently in testimony prepared by several participants in proceedings conducted last month before the NARUC Ad Hoc Committee on Utility Diversification.

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[4] It should be emphasized that the issue of diversification of many utility companies is not before this Subcommittee as it considers legislation regarding the Public Utility Holding Company Act. This is because the Holding Company Act threatens no meaningful direct or indirect restraints on diversification unless a holding company structure is used. Consequently as the utility industry is presently structured, roughly 20 percent of the industry is subject to direct supervision of diversified business activity of the SEC under the Act (i.e., registered companies); most of these have diversified, but have confined their activities to functionally related enterprises, principally fuels supply and associated transportation. Another 20 percent of the industry (i.e., the exempt companies) is potentially subject to indirect restraint borne of the broad administrative latitude which resides in the SEC to condition or withdraw an exemption if the company's diversification exceeds the limits of the SEC's tolerance of diversified activities, as enunciated in In re Pacific Lighting Corp., SEC Holding Co. Act Release No. 17,855 (Jan. 11, 1973); In re National Utilities & Industrial Corp., 45 S.E.C. 167 (1963). For the remainder of the electric utility industry (i.e., independent operating companies), the nature and extent of controls on diversified activity is singularly a question of state law.

In general, successful diversification lowers a company's cost of capital both through diversification of risk and through the improvement in the firm's growth and earnings potential. With respect to diversification of risk, the obvious must be conceded at the outset. If a utility diversifies into riskier businesses than the utility business, the diversification would add to the company's perceived risk characteristics and thus could raise the utility's cost of capital.[5] However, as Carl Seligson of Merrill-Lynch points out, the measure of the risk of any investment is the difference between the expected return on investment and the actual return. By this standard, utility stocks, which in 1980 earned actual returns 3.1% below their allowed returns, are themselves risky investments.[6] Given the variations from expected returns currently characteristic of most utilities, Seligson concluded that "in nearly all presently foreseeable circumstances, the deployment of resources into other businesses will serve to diminish rather than increase risk," thereby lowering the utility's costs of capital.

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[5] It should be emphasized, however, that even when this occurs, rate regulatory methodologies exist which permit ratemaking authorities to allocate these higher costs to the non-utility side of the firm, thereby insulating ratepayers from the costs of increased risk.

[6] Testimony of Carl H. Seligson, Merrill Lynch White Weld Capital Marketing Group before the NARUC Ad Hoc Committee on Utility Diversification (May 6, 1982). Seligson noted that other risks borne by utility investors are inadequate or untimely rate increases; sharply higher operating, maintenance, and capital costs; environmental and licensing delays; and reduced certainty of demand forecasts.

Other testimony at the NARUC proceedings, as well as information derived from an exhaustive study of utility diversification by the Cabot Consulting Group demonstrate in other ways the benefits of diversification. I will provide these materials to the Committee or comment upon them more fully if it would be useful. I attempt only to summarize them here:

(1) The Cabot study points out that utility diversification into counter-cyclical lines of business, such as fuel supply, tends to stabilize overall earnings, benefiting shareholders.[7] (Any consequent decrease in the cost of capital would of course benefit ratepayers.) The Cabot study also demonstrates the point, strongly endorsed by utility analysts,[8] that the ratepayer savings also arise from the "synergistic" application of excess utility assets or untapped managerial skills to the diversified business.

(2) Most utilities lack both the desire or necessary capital to deploy significant portions of their assets into non-utility businesses. However, a recent Merrill Lynch study indicates that even a modest diversification strategy can better the utility's position in the capital markets. Examining 90 diversified utilities, only five of which derived 10 percent or more of their net income from diversified

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[7] Cabot Consulting Group, Diversification in the Utility Industry (March 1982).

[8] E.g., Testimony of John W. Barr, Morgan Stanley & Co., Inc., before the NARUC Ad Hoc Committee on Utility Diversification (May 6, 1982).

activities, Merrill Lynch found that "the market-to-book ratio for these companies was 67 percent higher than for other electric companies, with the market paying a premium both for the diversification _per se_ and for the higher return on equity resulting from the diversification."[9]

(3) An argument is sometimes raised that diversification of risk may be better accomplished by diversification of an individual investor's portfolio. Even if this were true as a matter of investment portfolio management, the point cannot support a public policy judgment that utilities should be barred from diversified business ventures.[10] As one utility analyst points out: "An electric utility has a distinct financial profile. During heavy construction periods, it throws off tax benefits, and absorbs cash. . . . Financial synergy can arise from diversification into a business with a complementary financial profile: cash generating, able to utilize tax shelter, and perhaps with a cyclical earnings pattern . . ."[11] To prohibit utility diversification in deference to the benefits of individual portfolio diversification would deny the utility an opportunity to become a more attractive investment and would thereby deny ratepayers the benefits of decreased cost of capital attributable to diminished risk.

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[9] Testimony of Carl H. Seligson, _supra_ n.6.

[10] It should also be noted that even from the perspective of individual investors, portfolio diversification is not always the most attractive option. Charles A. Benore, a utility analyst for Paine Webber Mitchell Hutchins, Inc. has testified before this Subcommittee that in his professional view, diversified utilities on the whole are more attractive investments than utilities whose operations are confined to the traditional electricity generation, transmission and distribution business.

[11] Statement of John W. Barr, _supra_ note 8.

As these analyses demonstrate, diversification can better the position of shareholders and capture measurable direct savings for utility customers. Also of significance to customers is the potential benefit of diversification to the utility business, in the form of improved capability of utility management. Customers are fundamentally dependent upon the ability of management to skillfully steer the utility companies through their current financial difficulties. Diversification provides an opportunity to tone and enhance management capability. In some cases, business planning techniques learned in unregulated sectors of the firm may be effectively adapted to the utility business to lower costs or improve service. In addition, the opportunity for greater mobility within a firm can attract new talent to the utility business.

These enumerated benefits commend the diversification option to many utility managers as one element in an overall corporate plan to strengthen the financial condition of a utility company or system. I believe a brief description of one such corporate strategy developed for our system, which we call NEESPLAN, can help the Committee to appreciate the place of diversification in the range of alternatives for growth that should be available to utility companies. I also hope that the Committee's understanding of NEESPLAN will help to allay concerns expressed at the April hearings that diversification may divert the attention of management away from the utility business.

In 1979, NEES was a primarily oil-based utility system, facing high marginal costs and a 3 percent projected annual growth rate. Our stock was selling well below book. Under these financial circumstances we sought out alternatives for decreasing our costs, securing our utility service, and bettering our stock position without continuing to pursue costly capital to finance additional generation facilities. We therefore developed a five-part corporate program, which contemplated among other things that NEES would pursue diversified business opportunities. However, diversification is only one aspect of NEESPLAN. The keystone of our five programs is an aggressive conservation and load management program. A second aspect involves conversion of many existing oil facilities to coal. We are investing in the development of oil and gas properties to reduce our reliance on foreign oil. We have also begun to look at alternative energy development, in addition to investigating diversified business opportunities.

Our investment in diversified businesses has been cautious and incremental. And, our most established non-utility venture, the oil and gas project, is quite successful.. Though some of our ventures are in the formative stages, and cannot be appraised, I can say that thus far we have had no reverses.

The NEES experience confirms in very practical terms the arguments that diversification can capture the benefits of synergistic use of assets, personnel and technological capacity. Frequently, ideas for new projects grow from existing excess capacities. For example, we have developed an automatic load control mechanism which permits remote control meter reading. We have obtained SEC approval to market the device through a license and royalty arrangement with another independent company. And, to a great extent projects are suggested by the needs of the utility companies in our system. Our coal conversion program, however necessary to wean the system away from oil dependence, nevertheless imposed on our customers the considerable costs of coal transportation. We thus became interested in the coal ship described earlier which will transport coal to our generating facility at a savings to our customers of 10 percent of the market costs of this transportation.

I do not intend by this discussion to hold out NEESPLAN or even a diversification strategy as a paradigm of utility management. Nor would I encourage the Committee to expect that all utility diversification strategies will be pursued as we have pursued ours. Companies with different load expectations and different resources will face issues distinct from those confronted by NEES, and prudent management may dictate another corporate course. However, the point of my discussion is to emphasize that diversification need not be feared by policymakers as an opportunity for indiscriminate forays into speculation. Any commitment of the jealously guarded resources, and the all too elusive capital-raising capacity, of an electric utility system is certain to have at its root both reason and motives that are fundamentally consistent with the efficient and profitable operation of the electric utility business.

The experience of NEES and other diversified systems illustrates that utility diversification has a deserving place in the long-term strategic planning of many utility managers. I would suggest therefore that this Subcommittee may wish to test the validity of the Holding Company Act's limitations against the benefits to investors and ratepayers of utility systems shaped by modern management goals drawn from the current needs and objectives of the utility industry. That these goals may run afoul of 47-year-old conceptions of what constitutes a public utility structured and managed "in the public interest" or "the interests of investors and consumers" does not constitute justification for their continued application to utility holding companies of today.

Certainly one test of the validity of these controls is the cost to registered systems who must pursue the benefits of diversification subject both to the substantive prohibitions and the practical limitations arising from increased regulatory delays and the risks associated with regulatory scrutiny. The "functional relationship test" can defeat the synergistic benefits of diversification. For example, under-utilized utility personnel and assets, such as truck fleets or computer systems, or marketable technologies not applicable to utility service frequently can be applied to non-utility businesses. However, many of the business lines that could put these assets to full use are not functionally related and thus could not be pursued. This is true notwithstanding that the shared use of utility assets may result in savings to ratepayers.

Even when such businesses are permitted, the threat of public scrutiny of the terms of non-utility subsidiary contracts with unregulated third parties may dissuade unregulated parties from purchasing the services. Moreover, the time necessary to gain regulatory approval may increase costs of a project, or defeat the project completely. In one case I know of, a fuels supply subsidiary was understandably unable to persuade the sellers of attractive coal reserves to delay the sale until regulatory approval could be obtained, which as I've mentioned can take three to six months. When utilities in such circumstances lose out to unregulated buyers, they must either acquire less promising properties or forego entirely the benefits of secure supply gained by backward integration.

Moreover when presented with a precedent-setting case, SEC staff may take more than a year to complete an investigation and recommend approval of the venture, even when public hearings are not required. Full approval by the Commission may take as long as two years as was the case with our coal ship. And in that case we had the support and cooperation of the staff from the moment the proposal was first presented for their consideration.12/ And Keystone was a particularly patient co-venturer, willing to make commitments subject to subsequent approval by the Commission. Other unregulated co-venturers, who are accustomed to the freedom of shaping ventures to capitalize on timing advantages, have simply refused to immobilize capital pending review, and possibly disapproval, of a prospective project.

Thus far I have devoted considerable attention to the effect of section 11 on diversification. However, there is another vestigial effect of the SEC's continuing divestiture jurisdiction which potentially threatens, with varying degrees of seriousness, the financial well-being of three members of our group. This effect concerns the SEC's view that combination gas and electric utilities can not be joined in a single integrated utility system. As a result these three registered combined systems -- Northeast Utilities (NU), Middle

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12/ Although careful strategic planning, such as advance negotiation of construction and other contracts, can help to minimize these costs, many simply cannot be avoided. Again, the NEES coal ship demonstrates the point: although NEES was able to negotiate a fixed price contract for the ship's construction, that contract included typical provisions for escalation until regulatory approvals are secured and the agreements can be finally executed.

South, and AEP -- are subject to divestiture of their gas utility assets.[13/]

The SEC's position stems from the historic view that the Holding Company Act should foster competition between gas and electric utility systems, to promote the maximum utilization of energy resources. The SEC has recognized that the conservation objectives of energy policy have overtaken the Act's original purpose, but nevertheless finds itself constrained to follow its historic precedent, which has been judicially affirmed.

Enforcement of this anachronistic policy in the case of Northeast Utilities (NU), for example, would have only adverse effect on the the system's ratepayers and investors. Following an unsuccessful effort to dispose of their gas properties during the 1970's, NU conducted an extensive study during 1980 and 1981 of its options, including disposition. As part of that study, National Economic Research Associates, Inc. (NERA) examined the economies arising from the joint operation of the gas and electric properties. NERA's study concluded that disposition would result in continuing cost increases in the electric operations of approximately $2,000,000 a year, and continuing cost increases in the gas operations of approximately $4,000,000 a year.

[13/] See Columbia Gas Electric Co., 8 S.E.C. 443, 462 (1941).

Furthermore, due to the substantial difference between the embedded cost of capital associated with the gas properties and current market rates, NU concluded that it would only be possible to dispose of the gas properties at a substantial discount from their book value. A disposition of the gas properties below book value would have a diluting effect on shareholder equity.[14]

Here, as in other cases, the restrictions of the Holding Company Act have outlived their basis in public policy. Although their application today would be a detriment not a benefit to the interests of investors and consumers, the only meaningful remedy to the problem faced by combination companies is legislative relief from the enforcement of the simplification mandate.

Investor Protections

I have devoted a substantial portion of my testimony to the issues raised by Holding Company Act legislation with respect to diversification. This emphasis is dictated largely by the perception that our customers, utility regulators and many members of Congress view these questions as the most difficult ones to be addressed during the course of Congressional debate. However, for a number of the registered companies, who have no present plans to diversify, the "functional relationship test" and others of the Act's barriers to diversification are of minimal significance. In general the primary objective of these companies in joining our efforts is to be relieved of the extraordinary and burdensome controls on public sales of securities by registered companies, which the SEC continues to administer under the Act largely in the purported interests of investor protection.

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[14] Similarly, AEP predicts that if its subsidiary, Michigan Power Co., were required to divest its gas properties (which constitute approximately one half of its utility plant), Michigan Power's capitalization would have to be wholly refinanced at today's high cost, and would lose its lower imbedded costs of capital. The increase in rates necessitated by such higher capital costs would be immediate and dramatic.

Investor protection is intended to be secured under the Act by the requirement that the SEC approve the substantive terms of any financial transaction of significance, including the sale of securities to the public.[15] Registered companies are the only entities so constrained in their ability to obtain access to the capital markets. Capital raising is, of course, one of the most important tasks of utility management. And as noted above, few of the SEC's originally assigned tasks remain

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15/ The procedures for review of securities issues and assumptions of liability are also aimed at certain purposes of consumer protection, e.g., the protection of utility assets. The SEC's powers are plenary and their authority to direct the fashioning of holding company financing enables it to address a broad range of policy purposes. However, because the SEC's administration of these powers deals primarily with restrictions aimed at controlling the capital structures of registered systems, this discussion addresses them primarily as mechanisms of investor protection.

to be done, apart from the continuing review of financing and investment decisions. As a result, current administration of the Act is devoted primarily to the securities review function.[16]

The most appropriate point of departure for discussing the Act's securities controls is the basic question raised by the Chairman at the first day of hearings: what protective provisions with respect to securities issues under the Act or in the Commission's regulations continue to be necessary to protect utility investors?

Under the Act, there are three avenues available to the SEC to protect investor interests: the authority to require public reporting of the system's financing, capital structure and related matters; the authority to require that these reports comply with uniform accounting standards; and the authority to control the substance of security issues, including redemptive provisions, voting privileges, amount of stock to be issued, and the terms of its sale or placement (*i.e.*, competitive bidding versus negotiated sale or placement.) In the view of registered companies, these first

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16/ The registered systems' compliance costs illustrate this point. Although NEES is frequently before the Commission with respect to other matters, we estimate that approximately 60 to 70 percent of our compliance costs are incurred in gaining approval of our financing. Northeast Utilities, which is not diversified, estimates that 90 percent of its compliance costs are associated with securities issues.

two categories of authorities -- reporting requirements and accounting standards -- are unnecessary because they are duplicated in the federal securities laws which apply to virtually all publicly traded corporations, and by professional accounting standards. The third category, although not duplicated elsewhere is nevertheless also unnecessary and indeed disadvantages registered companies in their effort to compete with other unregulated companies in the capital raising markets. These controls are costly, do not improve the performance of our securities, and offer no investor protection that is not otherwise accomplished by the effective enforcement of traditional securities laws.

First, with respect to the question of investor information, registered holding companies file annual Form U-5-S, the contents of which are largely duplicative of the information also filed annually by registered companies in Form 10-K required under the Securities Exchange Act of 1934 ('34 Act) and in proxy solicitation materials, which must detail for shareholders all essential aspects of significant corporate transactions.[17] Certainly additional information respecting the terms of particular securities issues may be gleaned by investors from filings made to secure SEC approval of securities issues. However, there is no indication that investors rely upon this information to supplement that which is routinely available in public offering statements required under the Securities Act of 1933 ('33 Act).

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[17] Form U-5-S contains some additional information including the consolidated financial statements for the system and certain other information regarding corporate officials and employees, which are not deemed necessary under the '34 Act. However, much of this other information is included in FERC Form 1, which is also available to the public.

In addition the SEC aggressively pursues strict enforcement of its restrictions on insider trading and disclosure of misleading information. The SEC rules are buttressed by bodies of judicial interpretation that enhance the effectiveness of its provisions and expose violators to private causes of action.

The financial information disclosed under the '33 and '34 Acts must conform to an SEC prescribed uniform system of accounts, and must be audited by independent accountants according to accounting standards developed by the profession under SEC supervision. Auditors who vary from these standards are vulnerable to disciplinary action by the SEC. These accounting standards have proved so satisfactory that the SEC has abandoned its earlier rules prescribing separate standards for holding companies under the Holding Company Act, and expects investors to rely on the mechanisms applicable to other companies.18/ From all this, it is apparent that the investor

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18/ The SEC does prescribe other reporting requirements for holding companies. Some are generally required of all registered systems, and some apply to particular companies to permit the SEC to keep track of affiliate transactions. With respect to the former, application of the requirements does not

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gains no benefit from the disclosure of information or the regulation of accounting practices under the Holding Company Act that is not otherwise available under the securities laws of '33 and '34.

That the disclosure functions of the Holding Company Act are duplicative of other securities law should come as no surprise, for the Act is not truly a disclosure statute. Indeed the primary function of the securities review procedures as presently administered is to permit the SEC to direct the capital-raising efforts of utility management by requiring prior SEC approval of virtually all of the system's securities issues and assumptions of liability. This extraordinary regulatory control has no analogue in federal or state law.[19] Nor do any such controls apply to exempt companies and independent companies, which together comprise 80 percent of the utility industry. That circumstance may work to the

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yield information that could not be required to be disclosed under the '34 Act. Indeed, the SEC frequently uses this authority to impose disclosure requirements applicable to particular industries. Those requirements with respect to affiliate transactions are generally available to rate commissions which may review the reasonableness of affiliate transfer prices included in utility rates.

[19] Some states (and the FERC in the absence of state or SEC authority) are empowered to regulate securities issues and assumptions of liabilities by utilities, but this authority is not coextensive with the SEC's broad powers to dictate the financial structure of the entire system.

disadvantage of the registered companies, their investors and ratepayers, because compliance with these controls can be costly.

First, there are the problems of regulatory lag. The average time for review of an ordinary securities transaction is sixty days. During this time, the securities markets can change and advantageous circumstances -- such as a break in interest rates or a good market for the company's common stock -- may evaporate. Careful management can help to minimize these effects and in some cases contemporaneous review by state authorities may extend the delays beyond even that caused by the SEC. However, it is not infrequent that the time necessary for SEC review can force a company to bypass attractive opportunities to enter the securities markets to raise capital for its utility business.

The problem may be particularly acute when a company must lay before the SEC a request to increase its short-term borrowing limits. For example, an unexpected generation outage can rapidly escalate the amount of short-term debt. Such volatility cannot be "planned for" and regulatory delays in approving additional borrowings may impose significant interest penalties on the utility and its ratepayers.

Far more onerous than regulatory lag, however, is the burden of substantive restrictions on securities issues, such as the Commission's 1950's policy statements on first mortgage bonds and on preferred stock, and its strictly enforced requirement that registered companies select securities underwriters through competitive bidding. These problems are well developed in the testimony presented by Floyd Lewis and I will not attempt to repeat the points made so effectively in his presentation. However, I do want to underscore Mr. Lewis' point that the SEC's policies are rooted in historical concerns which are frequently not at work in today's trading markets. For example, the policy statement on first mortgage bonds requires certain redemption provisions for sinking and improvement funds. When a Florida utility used such a provision to redeem bonds otherwise subject to a no-call restriction, the market responded by, in effect, attaching a penalty to the inclusion of such redemptive provisions in future issues. Unregulated utilities can respond to this, simply by eliminating such provisions. Registered companies cannot, and suffer the consequences.

It may be useful to address the issue of the Commission's competitive bidding requirement, which the Chairman raised in the April hearing. It is interesting to note that in examining all the utility common stock issues of 1981 and 1982, one finds that the only issues undertaken through competitive bidding were those of registered companies who were required to do so by the SEC. And, during those difficult financial times, even those registered companies frequently sought exceptions to the requirement and made what they considered to be satisfactory sales through negotiated placement.[20/]

One such case is illustrative of the possible benefits of negotiated placement that may accrue if management is permitted to choose to respond to current market conditions in selecting its method of underwriting. For example, after the somewhat disappointing performance in 1981 of its competitively placed securities, NU, in the following year, gained an exception from the requirement, resulting in a very satisfactory placement of its securities through a negotiated offering. NU believes that the negotiated placement had several beneficial effects: it accelerated the timing to permit NU to enter the market when its stocks were selling at a five-year high; the negotiated underwriting discount was substantially lower than that secured in 1981 by competitive bid.[21/] Also, by using a negotiated rather than competitive offering, NU was permitted to "plus up" the share price an additional 1.8 at the time of sale.

[20/] In one case, In re Louisiana Power Co., Holding Co. Act Rel. No. 22,244 (Oct. 26, 1981) and Holding Co. Rel. No. 22,284 (Nov. 23, 1981), an exemption was granted only after competitive bids were uniformly, and unacceptably, high. The subsequent negotiated placement proved substantially less costly than the best of the competitive bids.

[21/] The discount in 1982 was 3.72 as compared to a 7.105 discount in 1981.

Finally, the negotiated placement permitted creation of a large selling syndicate, which may have had the effect of stimulating the secondary market for NU's outstanding common stock, with the result that both the trading volumes and the per share price increased prior to the offering, favorably affecting the new issue.

I should stress that many members of our group have indicated that they prefer competitive bidding and would continue to use it except when interest rates or other factors are adverse or unstable. This is because competitive bidding, like others of the staff-developed notions of what constitutes sound financial management may in certain circumstances coincide with the standards of business practice enforced by the marketplace. However, in many other cases the rigid application of financial policies developed in the context of the 1950's precludes registered companies from entering the highly competitive securities markets on equal footing.

In sum, it is our experience that the additional scrutiny provided under the Holding Company Act has no demonstrable effect on the performance of securities and thus cannot be justified on that ground. Therefore, we believe that the effective enforcement of financial disclosure requirements under the '33 Act and the '34 Act, coupled with the development of accounting principles and professional standards of general applicability, are fully adequate to protect investors in the marketplace.

Consumer Protections

Although the Holding Company Act is aimed largely at controlling corporate structure, there are some claimed consumer protections under the Act which should be examined as the subcommittee contemplates its repeal or amendment. Two issues identified by Chairman D'Amato concern the potential effects on consumers of utility diversification if the Act were repealed. Specifically, customers of diversified utilities are concerned that losses due to reverses in the non-utility businesses will impair the ability of management to raise capital necessary to provide reasonably priced utility service. Also, because repeal of the Act would eliminate the SEC's authority to review affiliate transfer prices and cost allocations, the Chairman has raised the question frequently posed by consumers whether state law is adequate to prevent interlocking management of utility purchasers and non-utility suppliers from passing through excessive charges to customers.

I should emphasize first that these questions are not of equal weight. Affiliate transfer pricing and cost allocation are legitimate questions of utility rate regulation and the Committee should properly be concerned whether the elimination of the SEC's authority creates a regulatory gap that cannot be bridged by rate regulation. (We believe it does not.) However, with respect to the question of consumer protections against diversified business losses, I would contend that the concern is much overstated, and that even in the event of such loss, any perceived protection to be gained from the Holding Company Act is illusory.

I have attached to my testimony a chart prepared for EEI which demonstrates that two factors must be present before diversification presents any risk to ratepayers. First, a utility would have to diversify substantially before business reverses would impair the earnings of the utility, thereby affecting its position in the capital markets. Second, these non-utility businesses would have to suffer significant losses, perhaps even total project failure, before it could measurably affect the utility side of the firm's earnings. Yet the record shows that we are very far from approaching either of those circumstances. Few electric utilities have deployed more than 10 percent of their assets in diversified ventures. And, perhaps more importantly, the experience thus far shows many measurable successes in electric utility diversification and no significant failures.

Nevertheless, failure is not impossible, and it may be argued that SEC review imposes prophylactic limits on the pace and extent of diversification, and thus on the degree of loss. However, as I mentioned in discussing our situation at NEES, utility diversification proceeds incrementally not because of SEC control but because the disciplines of the marketplace require it. The capital poor position of utilities precludes the hasty pursuit of an ambitious diversification strategy. If an initial step proves successful, the earnings produced and management and shareholder confidence gained will provide the basis for an expanded venture. This may lead to more substantial diversification and improved overall earnings. However, if things go poorly in the beginning or at some later time when further investments are planned to take place, retrenchment unaided by regulatory guidance is apt to occur. Moreover, there is simply no reason for customers to repose greater faith in the wisdom of the SEC than in that of management in assessing the risks and benefits of a particular diversified enterprise. The SEC staff brings to its review of non-utility investment no special insights or knowledge of business planning and management. In the absence of SEC controls, diversification undertaken wholly at the discretion of management will proceed within very substantial limits set by the nature of the companies' own resources and the prospects for business success.

As I've suggested, we give greater credence to customer concerns with respect to affiliate transactions. These concerns are legitimate in one essential respect: it is true that there exists a regulatory responsibility to insure that shared costs are properly allocated and that shared management does not charge the utility unreasonable costs for goods and services, to be passed through to customers. It is our view however that the SEC, working within the confines of the "cost standard" of the Holding Company Act, is neither the pre-eminent nor the appropriate forum for resolution of these issues.

At the time of enactment of the Holding Company Act, only twenty-two states regulated electric utilities rates and service. There was no regulation of interstate sales or transmissions of electricity.[22] The utilities themselves did not keep standard books and accounts. Therefore, the drafters of the Holding Company Act assumed federal authority over transactions between associated companies in the same holding company system. They required that all transactions be priced at cost which the SEC interprets as cost, plus a regulated rate of return. Unless an exception is granted in unusual (and rare) circumstances, the non-utility is typically allowed to earn only the utility rate of return set by FERC for the company's wholesale sales of electricity. And even profits from third-party transactions ordinarily are "recaptured" and credited to associated utility companies to subsidize the cost of goods and services they secure from their non-utility associates.

22/ Indeed, the Federal Power Commission was granted that authority in Title II of the bill that became the Holding Company Act.

The statutorily imposed inflexibility of the cost standard operates in marked contrast to the broad latitude granted to FERC to set "just and reasonable" rates under the Federal Power Act. There are meaningful advantages to this more flexible ratemaking standard, which is also employed as a principle governing state rate regulation. Rate regulators may select among a variety of pricing methodologies in regulating affiliate transfer prices to accomplish any number of regulatory objectives. For example, to encourage interstate pipelines to develop a more certain gas supply, the FERC in the 1960's eliminated the use of utility cost-of-service pricing for the pipelines' own gas production, and permitted them to collect the same rate designed to encourage independent gas production.

This latitude may be particularly significant with respect to electric utilities which have substantially diversified into fuel supplies, particularly coal. In Public Service Co. of New Mexico, the FERC recently rejected the use of cost-plus pricing for captive coal, in part because of its potentially adverse impact on customers. The FERC found it inappropriate to permit utilities to develop coal reserves free of the market constraints of competitive prices finding that there may be incentives to inefficiency inherent in applying cost-plus transfer pricing to non-utility ventures.

Moreover, although we look forward to passing on to our customers the benefits of cost savings, we believe that investors who bear the risk of diversified ventures are entitled to the profits from that investment.[23] We therefore strenuously object that the cost standard denies us the opportunity available to other utilities to make that case to the rate commissions.

Certainly, the benefits of regulatory flexibility would not be persuasive if it were the case that rate regulators of today still lacked the authority to resolve transfer pricing issues. However, this is clearly not the case. FERC frequently has used its auditing authority to investigate transfer pricing. Many states have affiliate transaction statutes that empower rate regulatory commissions to approve the terms of affiliate company contracts. In most cases judicial opinion and rate regulatory practice now support state commission investigation of non-jurisdictional affiliate accounts pertaining to transactions with the regulated utility and, most states are required by law to give such transactions special scrutiny.[24]

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[23] Perhaps the best method for accomplishing this is the use of a market-referenced price such as that used by FERC and several states. However, other states faced with difficulties in determining a market for comparison, have attempted to set a return on non-utility investment relative to its risk. Either of these methods accomplishes a more just result than the cost standard.

[24] A related concern is the issue of cross-subsidization of non-utility businesses by improper cost allocation. While it

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I would like to address one final question raised at the April hearings. Concern has been expressed that elimination of the SEC's authority over acquisitions and dispositions of utility securities would be an invitation to takeovers and, perhaps, the re-creation of holding company pyramids.

I assume that the Committee's primary concern here is not with electric utilities whose poor financial condition makes takeover unlikely, but with gas companies holding attractive reserve properties. However, with respect to electric companies, even in the absence of the Act, other significant impediments to takeovers remain under section 203 of the Federal Power Act (FPA). A direct acquisition of public utility assets would require approval of either the FERC or the forty-five state agencies which administer similar constraints. And if the Holding Company Act were repealed, section 204 of the Federal Power Act requires FERC to approve securities

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is true that the SEC prescribes accounting standards for allocation of shared costs among associate companies, this task has been primarily the responsibility of rate regulators. The FERC has for years regulated diversified pipelines and found little trouble in allocating costs, including costs of capital for purposes of setting allowed rates of return. States, too, have experience with these issues in their regulation of diversified electric and gas utilities and telephone holding companies. The point is that cost allocation presents problems of *methodology*, not of *authority*. Were they the latter, it would be understandable that Congress should be wary. However, the former are soluble and are the province of rate regulators.

issues of public utilities, if no state authority is otherwise controlling. Many states do assert such authority, through "little holding company acts" such as that in the Connecticut statutes or by requiring approval of any change in control by a utility which holds a franchise license.[25]

I cannot claim that we have examined the laws of fifty states and can assure the committee that in every case state authorities lie ready to fill any gap left by repeal of the Act. But I do know that existing state law is substantial and adequate to meet a great many situations. Perhaps more important is that any deficiency in the scope of state authority is statutory not constitutional. If regulatory gaps are discovered and public policy dictates they be closed, legislatures are fully empowered to do so.

However, the Committee should recognize that even if repeal of the Act resulted in some changes in utility ownership, it does not follow that the Act's retention is necessary to prevent the re-creation of holding company pyramids such as existed in 1935. Although this spectre may haunt this Committee's reconsideration of the Act designed to cure their "evils," the past simply cannot be recaptured. Too much has changed. It is hard to imagine that any group of

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25/ In addition to effecting control over utility acquisitions, states have used this authority to review corporate reorganization for the purpose of diversification and to set limits on the nature and extent of diversification through conditions of the franchise.

investors could amass the capital necessary to bring under common ownership significant portions of the electric utility industry. The modern securities markets and the SEC would detect widespread abusive investment practices such as manipulation of voting privileges long before even the most intricate ownership schemes could transform utility capital structures into the highly leveraged pyramids of the past. Indeed their very intricacies would raise the doubts of analysts, brokers, accountants and sophisticated institutional investors who could effectively preclude any profitable entry into the trading markets of a company which, for example, misrepresented its assets. And, rate regulatory authority exists to insure that holding companies may not drain the utility's revenue stream to finance these structures. For these reasons we are confident that repeal of the Act simply accomplishes the elimination of unnecessary regulation, in recognition of the fact that well developed utility and securities regulation are adequate to accomplish the purposes of effective utility holding company regulation.

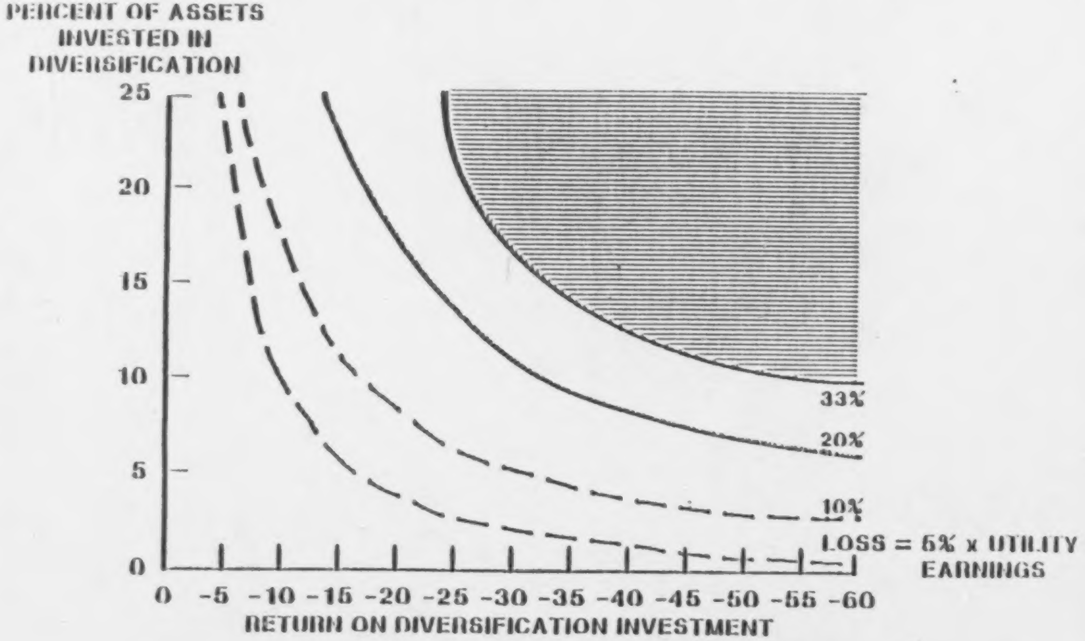
Conclusion

Mr. Chairman, and members of the Subcommittee, I hope this discussion has proved to be useful to your task. In my opinion, the case for repeal of the Holding Company Act is strong. It seems to be countervailed only by vague concerns, which upon examination do not appear to have much substance. I would ask the Subcommittee to give considerable weight to the unanimous opinion of the SEC that this Act has served its basic purpose and that continued federal regulation of holding companies is neither desirable or appropriate. And if the Subcommittee is inclined to leave this 47 year old statute on the books I would respectfully request that you clearly articulate the public policy reasons for doing so and that you consider whether there are more sensible, less burdensome ways of accomplishing those purposes.

Thank you for your courteous attention. I will be pleased to attempt to respond to your questions.

APPENDIX A

RISK OF EARNINGS ATTRITION



Source: Planmetrics Inc., Electric Utility Diversification: Simulation of Financial and Economic Impacts, prepared for EEI, January 1982.

Senator D'AMATO. Thank you very much, Mr. Nichols, Mr. Grigg.

STATEMENT OF WILLIAM H. GRIGG, EXECUTIVE VICE PRESIDENT, FINANCE AND ADMINISTRATION, DUKE POWER CO., CHARLOTTE, N.C.

Mr. GRIGG. Thank you, Mr. Chairman.

I very much appreciate this opportunity to testify on this very important issue affecting our Nation and the electric and gas utilities.

My name is William H. Grigg. I'm executive vice president for finance and administration of Duke Power Co., an independent operating company providing electric service to the central portion of North Carolina and western portion of South Carolina.

I am also representing an ad hoc group of just under 30 other utilities, some electric, some combination of gas and electric, and some gas companies, that have an interest in the Holding Company Act. Some of these companies are presently exempt holding companies under section 3 of the act, while others, like Duke Power, are not now subject to the act but are considering activities that could subject them to the act or that could be affected by reform of the act.

Senator D'AMATO. Mr. Grigg, before you get into your testimony, the specifics, let me ask you why would a company that is not under the act, not regulated by the act, then be interested in the outcome of these hearings?

Are we saying that you might in the future come under the act? Or why?

Mr. GRIGG. Yes, Mr. Chairman. Some companies, including my own—Duke Power Co. is not now subject to the act. We are an operating electric utility. We believe though—because of some of the diversified activities, we are considering that the holding company structure would be the desirable way to go, in the best interests not only of the investors but also of the consumers. If we were to form such a company, we would then become subject to the act and all the burdens—unnecessary burdens, we believe—which it imposes.

Senator D'AMATO. So, that there is an impediment to converting into a holding company structure as a result of the Act, from your perspective?

Mr. GRIGG. Exactly. It imposes a chilling effect on our desire to do what we think is best in the interests of our consumers and investors.

Senator D'AMATO. Could you address yourself to those particular aspects of the act that trouble you most.

Mr. GRIGG. Yes, sir, I think—in terms of the act?

Senator D'AMATO. Yes.

Mr. GRIGG. Yes, sir, the primary one, which has been averted to here, is the diversification by registered holding companies is limited to activities that are functionally related to those of the utility business. That's No. 1.

Even exempt holding companies, although the per se rule, the functional relationship test has not been applied on a per se basis to exempt holding companies, exempt holding companies nevertheless have been limited in diversified activities by some very precise, very strict guidelines that set forth by the SEC in a 2-2 decision some time ago.

Another problem, and perhaps one that for the exempt holding company is the most important of all, is the fact that the SEC, under the act, may revoke an exemption under a very vague standard. They may do so retroactively. And the effects, the result of a revocation can be very severe, particularly in the case of a combination gas and electric company.

Senator D'AMATO. So, those two aspects are your major concerns?

Mr. GRIGG. Those, in terms of limiting diversified activities. The act, with respect to registered companies, limits diversification to functionally related activities with respect to the exempt companies. Although the functional relationship test has not been applied on a per se basis, very strict limitations have been imposed. And the risk of not complying with those rules and regulations is the revocation of the exemption, which carries with it very great penalty.

Mr. Chairman, the distressing decline in the financial health of the electric utility industry is now almost universally recognized. It's a problem that our industry is attacking in several ways.

INDUSTRY SEARCHING TO IMPROVE FINANCIAL CONDITIONS

We are seeking to reform the ratemaking process to provide for the more complete and more timely recovery of costs. We are actively promoting conservation and load management programs. We are searching for low-cost alternative energy sources in order to minimize the need for new capital.

And finally, Mr. Chairman, much of the industry is exploring ways to reduce its risks and to improve its financial condition through entry into the more profitable nonutility businesses.

A recent study of the Cabot Consulting Group, copies of which have been furnished to the subcommittee staff, concludes that diversification can selectively help to increase earnings levels or decrease risk. And many in the investment community have recognized that although, to date, utility diversification has been relatively limited, diversified activities have financially helped reform nondiversified activities.

Mr. Chairman, diversified activities could best be carried out under the holding company structure. In the interest of both investors and consumers, it would facilitate, as Mr. Nichols pointed out, effective State regulation of the utility business. It would minimize the possibility of losses or liabilities to the utility and its ratepayers. It would prevent cross-subsidization, and it would facilitiate the raising of capital on more reasonable terms.

Precisely because it isolates the utility from the nonutility business, the holding company structure affords the greatest degree of protection to the consumer. And I think that speaks to many of the concerns that were expressed by Senator Lewis here in these hearings on Tuesday.

Unfortunately, however, the Holding Company Act presents barriers to the use of a holding company structure.

As I mentioned a moment ago, under the act, registered companies are limited to activities that are functionally related. They are subject to extensive and, we submit, unnecessary regulation by the SEC. And even exempt holding companies, as I mentioned, have been restricted in efforts to diversify because the exemption can be revoked upon a very vague standard retroactively applied, and the consequences of that are very severe.

This subcommittee has previously heard testimony to the effect that the act has served its basic purpose, which was the simplification of the corporate and financial structures of holding companies and regulation of their financial operations and of their accounting practices. Further, that continued Federal regulation of utility holding companies is unnecessary or inappropriate.

I concur fully with that view, and I'd like to take just a very few moments to address the concern that we have heard expressed in these hearings that State and Federal regulation of public utilities may not be adequate to protect the public interest should the act be repealed or amended.

Mr. Chairman, the structure of this industry and the extent to which it is regulated today are far, far different than in 1935. Today, utilities operate single, regionalized, integrated systems which are amenable to effective State regulation. That was not true in 1935. Virtually every State public service commission, as well as the Federal Energy Regulatory Commission, establishes rates for electric and gas service.

State public service commissions and the FERC have the authority to limit recovery of expenditures by a public utility to those which are reasonably necessary for the conduct of the utility business, thereby avoiding cross-subsidization.

The issuance of securities by a public utility is regulated either by State public service commissions or by FERC, pursuant to section 204(A) of the Federal Power——

Senator D'AMATO. Mr. Grigg, going back to your statement that the State commission has the ability to regulate the rates to protect the ratepayers, how do you see that regulation operating under the holding company structure, particularly an interstate holding company? Doesn't that complicate the ability of a State regulator to reach the basis upon which companies submit their data?

ALLOCATION OF COSTS

Then add to that the element of diversification. How can a regulator attempt to allocate costs where you have management for one business that is being charged off from management for another? Don't you see that as a potential problem?

Mr. GRIGG. Mr. Chairman, that's exactly the situation today with Duke Power Co. We operate in two States, North Carolina and South Carolina. The North Carolina Utilities Commission regulates our retail operations in that State. There's a cost allocation problem there. The Public Service Commission of South Carolina regulates our operations at the retail level in that State. They do the same thing. Our wholesale rates are regulated by the FERC in Washington.

So there's already multistate regulation of Duke Power Co.'s utility operations. That's been done very effectively for the last 70-plus years.

In addition, Mr. Chairman, Duke Power Co. is diversified to some extent and has been so for over 72 years. We operate Mill Power Supply Co., which was initially founded to provide large equipment to primarily industrial owners who wanted to convert from water power that go to textile mills down the river. They wanted to convert from water power to electric energy. They didn't have the ability to do that. Mill Power was formed to fill that need. Mill Power was selling electric equipment for 72 years and has expanded its business beyond its original conversion activities into other areas of electrical equipment.

Mill Power sells equipment to Duke. Those operations—those transactions between Duke and its affiliates have been regulated—not for 72 years, since the founding of the State commissions under a system which the commissions themselves put in place. We keep separate books and records. They're audited. Any transactions between the affiliate and Duke are done at cost. Mill Power sells Duke the equipment at the same price it sells to a third party. Then, there's a profit elimination we make on the books of the company to make sure the ratepayers don't pay any of that cost.

Senator D'AMATO. So, what you're saying is you feel the local State regulatory agencies will have the ability to reach these transactions?

Mr. GRIGG. Mr. Chairman, not only will have, they've been doing it in our case of 72 years.

Senator D'AMATO. They haven't done it in my State, I'll tell you that. [Laughter.]

They can't even deal with a little water company that's been playing games with them for years.

Mr. GRIGG. We have a coal mine subsidiary, and the same arrangement takes place. We have another subsidiary which owns substantial acreage. Those transactions are at cost. We keep separate books and records; pursuant to requirements of the commissions, there is a profit elimination. To my knowledge, the question of cross-subsidization, the question of the inadequacy of the State to deal with that situation has never been raised.

Senator D'AMATO. So, what you're suggesting is that would be the proper exercise of State legislative authority to deal with the adequacy or inadequacy of the authority, the legislative authority granted to their commissions, or maybe even the inadequacy of a commission itself?

Mr. GRIGG. Exactly, Mr. Chairman.

I would reemphasize the point Mr. Nichols made. The best way for them to do that is through the holding company structure, because the holding company is entirely separate and apart from these other operations. There is a cleaner, clearer division of the utility from the nonutility operations, which ought to make regulation more effective and easier to accomplish.

Today, Duke operates with the subsidiaries I mentioned as subsidiary to the parent operating company. Duke Power Co.'s financial condition is affected by their financial results because we are consolidated. If they can be moved out into separate entities, I think greater protection would be afforded the consumer. And I think that regulation would be facilitated.

STATE APPROVAL NECESSARY

Mr. Chairman, in response to concerns that have been expressed in these hearings over utility combinations or mergers—and I think particularly by the American Public Power Association—let me say, first, that State public service commissions have broad authority under existing law to regulate any potential utility combination that may be inconsistent with the public interest. This includes public service commission approval of the acquisition of the securities or assets of the public utility or the sale of utility assets.

Under section 203(A) of the Federal Power Act, FERC approval is required for the acquisition or disposition of assets that are subject to that commission's jurisdiction, as well as for the merger or consolidation of those assets with those of another utility.

And the corporate laws of most States require shareholder approval after full disclosure and proxy statements, pursuant to SEC rules and regulations of the merger or of the sale of all or substantially all of the corporation's property.

So, the problems that cause the Holding Company Act to be adopted in the first place, the pyramiding, the intricate structure, simply cannot recur today, because State commission approval would be required, FERC approval would be required, and shareholder approval would be required, after full disclosure, pursuant to the SEC's own rules and regulations.

A brief word about affiliate transactions, which concern Mr. Roberts this morning. Both FERC and State public service commissions have broad authority to scrutinize transactions among affiliates, both within and outside the holding company systems. In fact, as I indicated a moment ago, many State commissions—certainly in North Carolina and South Carolina—have been doing so for a number of years.

Transactions among affiliates are also regulated in the ratemaking process, with disallowance by public service commissions and FERC of any charges that are found to be unreasonable.

Mr. Chairman, if the Holding Company Act is repealed, as we have heard this morning, the Securities Act of 1933 and the Exchange Act of 1934 provide investors and the public with detailed information on an ongoing basis concerning the financial condition and the operation of public corporations.

The Trust Indenture Act of 1939 prescribes strict standards for indentures and trustees of debt securities sold to the public and in virtually every State has securities or blue-sky laws that regulate the sale of securities in that State. One of the major abuses, in fact one of the two major objectives of the 1935 act was the regulation of a utility holding company's accounting and financial practices. Today, unlike 1935, utilities are subject to stringent accounting controls, detailed controls. These include the uniform system of accounts promulgated by FERC, similar controls at the State level. Utilities are subject to detailed accounting rules by the SEC's SX with respect to disclosure matters, also by the financial accounting standards boards.

In summary, Mr. Chairman, since 1935 a pervasive and effective system of State and Federal regulation of public utilities has been put in place. This regulation, overlayed with disclosure requirements of the 1933 and 1934 acts and the application of strict accounting standards and practices, should cause any contention that the Holding Company Act is necessary for effective public utility regulation to be viewed, in my mind, with considerable skepticism.

Mr. Chairman, that concludes my remarks. I'll be happy to respond to any questions.

[The complete statement follows:]

STATEMENT OF

WILLIAM H. GRIGG
EXECUTIVE VICE PRESIDENT
FINANCE AND ADMINISTRATION
DUKE POWER COMPANY

SUBCOMMITTEE ON SECURITIES
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
JUNE 10, 1982

MR. CHAIRMAN, MEMBERS OF THE SUBCOMMITTEE, I VERY MUCH APPRECIATE THE OPPORTUNITY TO TESTIFY BEFORE YOU TODAY ON THIS IMPORTANT ISSUE AFFECTING OUR NATION'S ELECTRIC AND GAS UTILITIES. MY NAME IS WILLIAM H. GRIGG, AND I AM EXECUTIVE VICE PRESIDENT FOR FINANCE AND ADMINISTRATION OF DUKE POWER COMPANY, AN INDEPENDENT OPERATING COMPANY PROVIDING ELECTRIC SERVICE IN THE CENTRAL PORTION OF NORTH CAROLINA AND THE WESTERN PORTION OF SOUTH CAROLINA. AS SUCH, I AM RESPONSIBLE FOR ALL OF THE NON-REGULATED ACTIVITIES OF DUKE POWER'S CORPORATE SUBSIDIARIES. DUKE POWER COMPANY IS THE NINTH LARGEST INVESTOR-OWNED UTILITY IN THE UNITED STATES IN TERMS OF KILOWATT-HOUR SALES AND IS NOT NOW SUBJECT TO THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935. I AM ALSO REPRESENTING AN AD HOC GROUP OF JUST UNDER 30 ELECTRIC, COMBINATION GAS AND ELECTRIC, AND GAS UTILITIES THAT HAVE AN INTEREST IN THE HOLDING COMPANY ACT. SOME OF THESE COMPANIES ARE PRESENTLY EXEMPT HOLDING COMPANIES UNDER THE ACT, WHILE

OTHERS, LIKE DUKE, ARE NOT NOW SUBJECT TO THE ACT BUT ARE CONSIDERING ACTIVITIES THAT COULD SUBJECT THEM TO THE ACT OR THAT COULD BE AFFECTED BY REFORM OF THE ACT.

MR. CHAIRMAN, WE AGREE WITH MUCH OF THE TESTIMONY THAT HAS PREVIOUSLY BEEN PRESENTED TO THIS DISTINGUISHED SUBCOMMITTEE, THE BASIC THRUST OF WHICH IS THAT THE HOLDING COMPANY ACT NO LONGER SERVES ANY USEFUL PURPOSE. WE ALSO WANT TO STRESS OUR BELIEF THAT THE ACT NOW IMPOSES UNNECESSARY AND, IN SOME CASES, WHOLLY UNINTENDED REGULATORY BURDENS ON A FINANCIALLY PRESSED INDUSTRY. AT THE PRESENT TIME, THESE REGULATORY BURDENS ARE ACTUALLY WORKING AGAINST THE BEST INTERESTS OF INVESTORS AND CONSUMERS. SINCE THIS FACT HAS BEEN RECOGNIZED BY BOTH THE SECURITIES AND EXCHANGE COMMISSION (SEC) AND THE ELECTRIC AND GAS UTILITY INDUSTRY, IT SHOULD BE A SIGNIFICANT SIGNAL TO CONGRESS THAT THE SUBJECT IS RIPE FOR ACTION.

BY ALMOST ANY FINANCIAL MEASURE, THE ELECTRIC UTILITY INDUSTRY IS EXPERIENCING SERIOUS FINANCIAL DIFFICULTIES. THIS IS DUE, IN LARGE PART, TO THE FACT THAT THE BASIC ECONOMIES OF THE INDUSTRY CHANGED SOME 15 YEARS AGO, AND IT IS NO LONGER, AS IT ONCE WAS, A DECREASING COST INDUSTRY. IN PREVIOUS TESTIMONY BEFORE THIS SUBCOMMITTEE, MR. CHARLES BENORE, SENIOR VICE PRESIDENT OF THE INVESTMENT BANKING FIRM OF PAINE WEBER MITCHELL HUTCHINS, CHARACTERIZED THE FINANCIAL INTEGR-

ITY OF THE INDUSTRY AS "AT A LOW, NEAR DANGEROUS LEVEL", WHILE CONGRESSMAN CORCORAN WARNED OF THE "DEVASTATING IMPACT ON THE NATION'S ECONOMY" IF THE INDUSTRY'S FINANCIAL DIFFICULTIES WERE ALLOWED TO CONTINUE.

DESPITE SOME RECENT IMPROVEMENT, THE COMMON STOCKS OF MOST UTILITIES ARE STILL SELLING WELL BELOW THEIR BOOK VALUES AS COMPARED TO THE INDUSTRY AVERAGE OF 250% OF BOOK VALUE AS RECENTLY AS THE 1960S. THE REASONS FOR THIS DECLINE ARE QUITE SIMPLE. AS THE COMMITTEE ON ENERGY OF THE ASPEN INSTITUTE POINTED OUT, "DIVIDENDS TO STOCKHOLDERS, WHICH WERE FORMERLY A MAJOR ATTRACTION FOR [UTILITY] INVESTORS, HAVE DECLINED . . . IN REAL TERMS. THE AVERAGE YIELD . . . WHEN ADJUSTED FOR STOCK PRICE DECLINES, IS WELL BELOW THE AVERAGE TOTAL INVESTOR RETURNS FROM INDUSTRIAL STOCKS OR OTHER COMPETITIVE INVESTMENTS." AS A RESULT, UTILITIES HAVE FOUND IT INCREASINGLY DIFFICULT TO ATTRACT EQUITY CAPITAL. IN FACT, PACIFIC GAS & ELECTRIC COMPANY AND THE INDIVIDUAL COMMISSIONERS OF THE CALIFORNIA PUBLIC UTILITIES COMMISSION HAVE RECENTLY BEEN SUED BY A STOCKHOLDER OF THE COMPANY FOR CAUSING NEW COMMON STOCK TO BE ISSUED TO THE PUBLIC AT A PRICE BELOW BOOK VALUE.

SIMILAR DIFFICULTIES HAVE CONFRONTED UTILITIES WITH RESPECT TO THEIR DEBT SECURITIES. UTILITY BOND RATINGS HAVE

BEEN FALLING, REFLECTING THE INVESTMENT COMMUNITY'S BELIEF THAT THE INDUSTRY'S ABILITY TO SERVICE ITS DEBT HAS BEEN DECLINING. FOR EXAMPLE, ACCORDING TO STANDARD & POOR'S, IN 1970, 8% OF ELECTRIC UTILITY BONDS HAD THE HIGHEST RATING, AAA, WHILE ONLY 4% HAD THE LOWEST "INVESTMENT GRADE" RATING, BBB. BY NOVEMBER 1981, 32% OF SUCH BONDS WERE RATED BBB WHILE ONLY 2% WERE RATED AAA. THIS DETERIORATION IS ALSO EVIDENCED BY THE FACT THAT IN 1980, 28 UTILITIES HAD THEIR BOND RATINGS LOWERED WHILE ONLY THREE HAD THEM RAISED. AS YOU KNOW, LOWERED BOND RATINGS RESULT IN HIGHER INTEREST CHARGES THAT ARE ULTIMATELY REFLECTED IN CUSTOMER BILLS.

THE DRAMATIC DECLINE IN THE FINANCIAL CONDITION OF THE UTILITY INDUSTRY HAS HAD VERY UNFORTUNATE EFFECTS ON BOTH INVESTORS AND CONSUMERS. IN HIS RECENT TESTIMONY BEFORE A COMMITTEE OF THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS (NARUC), MR. JOHN W. BARR OF MORGAN STANLEY & CO. INCORPORATED SUGGESTED THE FOLLOWING:

> THE INVESTORS--BOTH INSTITUTIONAL AND INDIVIDUAL--IN UTILITY SECURITIES HAVE SUFFERED HUNDREDS OF MILLIONS OF DOLLARS OF LOSSES IN THE MARKET VALUE OF THEIR SECURITIES, BOTH DEBT AND EQUITY, RESULTING FROM REPEATED DOWNGRADINGS OF DEBT SECURITIES AND INADEQUATE EARNED RETURNS ON THEIR EQUITY INVESTMENTS. THEY WOULD HARDLY AGREE THAT THEY HAVE AVOIDED RISK BY BUYING UTILITY SECURITIES. ALTHOUGH SUCH SECURITIES WERE ONCE VIEWED AS A "SAFE HAVEN" BY INVESTORS, THEY ARE NOW VIEWED WITH CAUTION BECAUSE THEY INVOLVE A KIND OF DOUBLE JEOPARDY: PRESENT ARE THE NORMAL

> BUSINESS RISKS FOUND IN OTHER INDUSTRIES, BUT OVERLAID ARE . . . REGULATORY AND JUDICIAL RISKS . . . INVESTORS HAVE COME TO REALIZE THAT UTILITIES ARE NOT BENEFICIARIES OF THE NATURAL MONOPOLIES IN WHICH THEY OPERATE. INSTEAD UTILITIES HAVE SUFFERED THE PENALTIES OF A MONOPOLY: THEY HAVE BEEN FORCED BY THEIR OBLIGATION TO SERVE CUSTOMERS TO ADD ASSETS TO THEIR RATE BASE WHICH EARN SUBSTANTIALLY LESS THAN THE COST OF FINANCING THOSE ASSETS. FOR A NON-REGULATED COMPANY THE CAPITAL BUDGETING DECISION IS EASY TO MAKE WHEN THE "HURDLE" RATE IS NOT MET. BUT UTILITIES ARE NOT FREE TO MAKE THIS DECISION.

I WOULD LIKE TO SHARE WITH THE SUBCOMMITTEE SOME OF THE RISKS THAT THE INVESTMENT COMMUNITY CURRENTLY ASSOCIATES WITH THE UTILITY INDUSTRY. FIRST OF ALL, THERE IS THE FUNDAMENTAL FINANCIAL RISK FOUND IN AN INDUSTRY WHERE CREDIT RATINGS HAVE BEEN DETERIORATING, INTEREST COVERAGES HAVE BEEN DECLINING AND REGULAR ACCESS TO THE CAPITAL MARKETS IS IN JEOPARDY. SECONDLY, THERE IS THE RISK THAT DUE TO INFLATION, RISING FUEL COSTS AND THE GENERAL REGULATORY ENVIRONMENT, UTILITIES WILL CONTINUE TO BE FORCED TO DELAY OR CANCEL CONSTRUCTION OF NEEDED FACILITIES, WITH INVESTORS BEARING ALL OR PART OF THE COST OF SUCH DELAYS OR CANCELLATIONS. THIRDLY, IN THE EYES OF INVESTORS, THERE ARE REGULATORY AND JUDICIAL RISKS THAT AFFECT ALL ASPECTS OF THE BUSINESS. ACCORDING TO PAINE WEBBER MITCHELL HUTCHINS, THE RISK OF UTILITY STOCKS, MEASURED AS A STANDARD DEVIATION OF RETURNS, HAS BEEN COMPARABLE TO THAT OF OTHER STOCKS, AND SURVEYS BY

THE SAME FIRM INDICATE THAT MANY INVESTORS NOW CONSIDER INVESTMENTS IN UTILITY SECURITIES TO BE "RISKIER" THAN INVESTMENTS IN SECURITIES OF INDUSTRIAL COMPANIES. RETURNS MUST ACCURATELY REFLECT RISK IF THE UTILITY INDUSTRY IS TO CONTINUE TO ATTRACT NEEDED CAPITAL.

BECAUSE UTILITY RETURNS HAVE BEEN INADEQUATE, CAPITAL HAS BEEN FLEEING THE INDUSTRY FOR INVESTMENT OPPORTUNITIES THAT OFFER REWARDS THAT ARE COMMENSURATE WITH THE RISKS INVOLVED. AS A RESULT, UTILITIES HAVE BEEN EXPERIENCING HIGHER COSTS OF CAPITAL THAT ARE ULTIMATELY BILLED TO CONSUMERS THROUGH THE RATEMAKING PROCESS.

THE UTILITY INDUSTRY HAS BEEN ACTIVELY PURSUING A NUMBER OF ALTERNATIVE SOLUTIONS TO ITS FINANCIAL PROBLEMS. THESE INCLUDE: A) A REDUCTION OF CAPITAL REQUIREMENTS THROUGH MORE EFFICIENT USE OF EXISTING PLANT FACILITIES, LOAD MANAGEMENT TECHNIQUES, TIME-OF-DAY PRICING, DEVELOPMENT OF ALTERNATE ENERGY SOURCES AND ENERGY CONSERVATION EFFORTS; B) REFORM OF THE RATEMAKING PROCESS TO PROVIDE FOR ADEQUATE AND TIMELY RECOVERY OF OPERATING AND CAPITAL COSTS THROUGH, AMONG OTHERS, PROVISIONS FOR FORWARD-TEST PERIODS, MORE EFFECTIVE FUEL COST RECOVERY PROCEDURES, EXPEDITED GENERAL RATE PROCEEDINGS, ATTRITION ALLOWANCES TO OFFEST THE EFFECTS OF INFLATION, AND CONSTRUCTION WORK IN PROGRESS IN RATE

BASE; AND C) HIGHER, MORE STABLE EARNINGS THROUGH SELECTIVE DIVERSIFICATION INTO COMPATIBLE, NON-REGULATED BUSINESS ACTIVITIES.

THE QUESTION OF DIVERSIFICATION HAS PARTICULAR RELEVANCE TO THESE PROCEEDINGS. IT IS A BUSINESS OPTION AND PRACTICE NORMAL TO MOST INDUSTRIES WHICH IS NOT AS A PRACTICAL MATTER SIMILARLY AVAILABLE TO UTILITIES. THIS IS DUE TO THE UNNECESSARY BARRIERS IMPOSED BY THE HOLDING COMPANY ACT.

SOME WHO HAVE TESTIFIED BEFORE THIS SUBCOMMITTEE HAVE SUGGESTED THAT EVEN IF, AS I BELIEVE IS THE CASE, THE HOLDING COMPANY ACT NO LONGER SERVES ANY USEFUL PURPOSE, THERE IS NO REAL HARM IN LEAVING THE ACT UNCHANGED. MR. CHAIRMAN, I RESPECTFULLY SUBMIT THAT IN VIEW OF THE DRAMATIC DETERIORATION OVER THE LAST 15 YEARS IN THE FINANCIAL CONDITION OF THE INDUSTRY, EVERY UNNECESSARY AND UNWARRANTED REGULATORY BURDEN MUST BE REMOVED IF THE UTILITY INDUSTRY IS TO CONTINUE TO PROVIDE THE SERVICE THAT THE CITIZENS AND INDUSTRY OF OUR NATION REQUIRE.

IN AN EARLIER HEARING BEFORE THIS SUBCOMMITTEE, OTHERS REFERRED TO THE LETTER, DATED DECEMBER 21, 1981, ADDRESSED TO YOU BY CHAIRMAN SHAD OF THE SEC, IN WHICH HE EXPRESSED THE UNANIMOUS POSITION OF THE SEC THAT THE

HOLDING COMPANY ACT "HAS SERVED ITS BASIC PURPOSE AND THAT CONTINUED FEDERAL REGULATION OF UTILITY HOLDING COMPANIES IS UNNECESSARY AND INAPPROPRIATE." WE AGREE WHOLEHEARTEDLY WITH THIS STATEMENT BY THE SEC.

CHAIRMAN SHAD INDICATED IN THIS LETTER THAT THE "ABUSES"* THAT LED TO THE PASSAGE OF THE HOLDING COMPANY ACT "ARE UNLIKELY TO RECUR IN LIGHT OF THE EXTENSIVE CHANGES SINCE 1935 IN THE PUBLIC UTILITY AND INVESTMENT BANKING INDUSTRIES, THE ACCOUNTING PROFESSION, STATE UTILITY REGULATION, EXPANSION OF THE DISCLOSURE REQUIREMENTS UNDER THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934, AND THE DEVELOPMENT OF MORE EFFICIENT AND WELL-INFORMED SECURITIES MARKETS." MR. CHAIRMAN, I WOULD LIKE TO ELABORATE ON SEVERAL OF THESE POINTS.

THE UTILITY INDUSTRY HAS CHANGED DRAMATICALLY SINCE 1935 WHEN THE HOLDING COMPANY ACT WAS PASSED TO REGULATE THE MANNER IN WHICH NATIONWIDE PUBLIC UTILITY HOLDING COMPANIES CONDUCTED AND FINANCED THEIR OPERATIONS.

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* IN 1928, THE UNITED STATES SENATE ORDERED THE FEDERAL TRADE COMMISSION (FTC) TO STUDY THE PUBLIC UTILITY INDUSTRY AND TO REPORT ITS FINDINGS TO THE SENATE. THE STUDY CULMINATED IN A NEWS RELEASE LISTING 19 "ABUSES AND EVIL CONDITONS" THAT LED TO PASSAGE OF THE ACT. THEY ARE ATTACHED AS ANNEX A HERETO.

In 1938, for instance, there were 214 registered holding companies controlling 922 electric or gas utility subsidiaries. Pursuant to Section 11(b) of the Act, described variously in 1935 as the "heart of the Act" or the "death sentence", the SEC began a vigorous program of forced divestitures designed to break up such holding company systems by integrating utility operations and by spinning off geographically unconnected operations. This SEC mandated divestiture program employed nearly 250 people in the Division of Public Utilities (now the Division of Corporate Regulation) in the 1940s. Today, by contrast, there are only 14 registered holding companies, over 300 independent electric and gas utility operating companies, and fewer than 20 people on the staff of the Division of Corporate Regulation. Clearly, the Act has accomplished its major purpose.

One of the principal reasons given at the time for breaking up the registered holding company systems was a concern that state regulation of public utilities was in its early stages. According to a 1977 statement by the SEC concerning the Holding Company Act, "[A] major purpose of the Act was to make possible, rather than to displace, state regulation" of public utility holding companies. Section 11 contemplated the development of effective state regulation

WHICH, IN FACT, HAS NOW TAKEN PLACE. THIS WAS TO BE FOLLOWED BY AN "EFFECTIVE SYSTEM OF ORDERLY DEREGULATION" WHEREBY FEDERAL CONTROL OVER UTILITY HOLDING COMPANIES WOULD BE REDUCED. AS THE SEC THEN SAID, "CONGRESS DID NOT INTEND THAT UTILITIES WOULD REMAIN PERMANENT FEDERAL WARDS UNDER THE ACT."

IT SHOULD BE CLEAR TODAY THAT REGULATION OF PUBLIC UTILITIES AT THE STATE LEVEL, ESPECIALLY WHEN CONSIDERED IN THE CONTEXT OF THE EXISTING OVERLAY OF OTHER FEDERAL LAWS RELATING SPECIFICALLY TO ELECTRIC AND GAS UTILITIES AS WELL AS TO MORE GENERAL FEDERAL LAWS SUCH AS THE SECURITIES AND ANTITRUST LAWS, IS MORE THAN ADEQUATE TO PROTECT THE PUBLIC INTEREST EVEN IF THE HOLDING COMPANY ACT WERE TO BE REPEALED. IN 1935, FOR EXAMPLE, THERE WERE ONLY 22 STATES THAT REGULATED THE RATES THAT UTILITIES WERE PERMITTED TO CHARGE THEIR CUSTOMERS. TODAY, VIRTUALLY EVERY STATE PUBLIC SERVICE COMMISSION, AS WELL AS THE FEDERAL ENERGY REGULATORY COMMISSION (FERC) WITH RESPECT TO WHOLESALE RATES, ESTABLISHES SUCH RATES. ADDITIONALLY, VIRTUALLY ALL STATE PUBLIC SERVICE COMMISSIONS HAVE BROAD SUPERVISORY POWERS OVER PUBLIC UTILITIES SUBJECT TO THEIR JURISDICTION, INCLUDING THOSE OVER FRANCHISES AND THE ISSUANCES OF CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY. BROAD STATUTORY GRANTS OF

AUTHORITY ARE OFTEN TIMES USED BY STATE PUBLIC SERVICE COMMISSIONS TO SUPPLEMENT SPECIFICALLY ENUMERATED STATUTORY POWERS.

CERTAIN OTHER AREAS OF STATE REGULATION OF PUBLIC UTILITIES WARRANT SPECIFIC MENTION BECAUSE OF THEIR RELEVANCY TO THE ISSUES PRESENTED IN THESE HEARINGS. FORTY-FIVE STATES, FOR EXAMPLE, SPECIFICALLY REQUIRE PRIOR APPROVAL BY A STATE PUBLIC SERVICE COMMISSION OF THE ISSUANCE OF SECURITIES BY A PUBLIC UTILITY. THE PURPOSES FOR WHICH SECURITIES MAY BE ISSUED BY PUBLIC UTILITIES ARE OFTEN LIMITED BY STATUTE TO THOSE RELATED TO THE UTILITY BUSINESS. SUCH STATUTES USUALLY MANDATE A STANDARD OF STATE PUBLIC SERVICE COMMISSION REVIEW OF PROPOSED SECURITY ISSUANCES DESIGNED TO PROTECT THE PUBLIC INTEREST. ADDITIONALLY, SECTION 204(A) OF THE FEDERAL POWER ACT AUTHORIZES FERC TO APPROVE THE ISSUANCE OF SECURITIES BY A PUBLIC UTILITY, OR AN ASSUMPTION OF LIABILITY WITH RESPECT TO THE SECURITIES OF ANOTHER PUBLIC UTILITY, UNLESS THE PUBLIC UTILITY IS ORGANIZED AND OPERATING IN A STATE UNDER THE LAWS OF WHICH ITS SECURITIES ISSUANCES ARE REGULATED. AS MR. SOLOMON FREEDMAN INDICATED IN HIS TESTIMONY BEFORE THIS SUBCOMMITTEE, SUCH STATUTES DO NOT CONTAIN PROVISIONS ANALOGOUS TO THE SEC'S STATEMENTS OF POLICY FOR

First Mortgage Bonds or Preferred Stock, but such authority is no longer needed in view of the existing securities disclosure requirements and increased sophistication in the investment community, as indicated in Chairman Shad's letter. Moreover, the Statements of Policy, which have actually increased the cost of capital to registered holding companies because of some of the terms mandated therein, are no longer required since the financial markets have changed considerably since the 1920s. Obviously, utilities can no longer dictate the terms of their securities offerings to investment bankers and the public as they were once able to do.

Another aspect of state regulation that merits specific discussion in view of the concerns expressed by the American Public Power Association is the fact that state public service commissions have sufficient authority under existing law to regulate any potential utility combinations that may be inconsistent with the public interest. For example, over half of the states require public service commission approval for the acquisition by a public utility of the securities or assets of another public utility. Virtually all of such states also regulate the sale of utility assets by requiring prior state public service

COMMISSION APPROVAL OF SUCH SALES. OTHER STATES PROHIBIT SUCH SALES TO COMPANIES THAT ARE NOT PUBLIC UTILITIES, WHILE CERTAIN OTHERS ALSO REQUIRE STATE PUBLIC SERVICE COMMISSION APPROVAL PRIOR TO THE ACQUISITION OF A CONTROLLING INTEREST IN A PUBLIC UTILITY.

IN ADDITION TO THE GENERAL APPLICABILITY OF THE FEDERAL ANTITRUST LAWS, SECTION 203(A) OF THE FEDERAL POWER ACT REQUIRES FERC APPROVAL FOR THE ACQUISITION OR DISPOSITION OF UTILITY ASSETS THAT ARE WITHIN THE JURISDICTION OF FERC, AS WELL AS FOR THE MERGER OR CONSOLIDATION OF THOSE ASSETS WITH THOSE OF ANOTHER UTILITY. SECTION 203 OF THE FEDERAL POWER ACT ALSO REQUIRES FERC APPROVAL FOR THE ACQUISITION OF SECURITIES OF ANOTHER PUBLIC UTILITY. ADDITIONALLY, THE CORPORATE LAWS OF MOST STATES REQUIRE SHAREHOLDER APPROVAL OF A MERGER OR A SALE OF ALL OR SUBSTANTIALLY ALL OF A CORPORATION'S PROPERTY, AND MOST PUBLIC UTILITY MORTGAGE BOND INDENTURES AND CHARTERS CONTAIN PROVISIONS PROTECTING THE RIGHTS OF SENIOR SECURITYHOLDERS IN THE EVENT OF SUCH A SALE OR MERGER. CLEARLY, THE INTERESTS OF INVESTORS AND CONSUMERS ARE ADEQUATELY PROTECTED.

FINALLY, I WANT TO BRIEFLY MENTION THE QUESTION OF AFFILIATE TRANSACTIONS. AS MR. FLOYD W. LEWIS, THE DISTINGUISHED CHAIRMAN OF MIDDLE SOUTH UTILITIES, EXPLAINED WITH SPECIFIC EXAMPLES IN HIS TESTIMONY, BOTH FERC AND THE

STATE PUBLIC SERVICE COMMISSIONS HAVE THE AUTHORITY TO SCRUTINIZE TRANSACTIONS AMONG AFFILIATES, BOTH WITHIN AND OUTSIDE HOLDING COMPANY SYSTEMS, AND, IN FACT, MANY STATE PUBLIC SERVICE COMMISSIONS HAVE BEEN DOING SO FOR DECADES. IN A LARGE NUMBER OF STATES, THIS AUTHORITY IS EXPLICITLY CONTAINED IN STATUTORY PROVISIONS REQUIRING SPECIFIC APPROVAL OF SUCH TRANSACTIONS, WHILE IN OTHER STATES TRANSACTIONS AMONG AFFILIATES ARE REGULATED IN THE RATEMAKING PROCESS THROUGH THE DISALLOWANCE BY THE STATE PUBLIC SERVICE COMMISSION OF ANY CHARGES FOUND TO BE "UNREASONABLE". IN THE EXERCISE OF ITS WHOLESALE RATEMAKING POWER, FERC ALSO MONITORS SUCH TRANSACTIONS. IN MY OPINION, CLAIMS THAT STATE REGULATION IS NOT ADEQUATE IN THIS AREA SHOULD BE GREETED WITH CONSIDERABLE SKEPTICISM.

TRANSACTIONS BETWEEN DUKE POWER COMPANY AND ITS WHOLLY-OWNED SUBSIDIARY, MILL POWER SUPPLY COMPANY, PROVIDE A PERTINENT ILLUSTRATION OF EFFECTIVE STATE REGULATION OF TRANSACTIONS AMONG AFFILIATES. FOR 72 YEARS MILL POWER HAS SOLD ELECTRICAL EQUIPMENT AND SUPPLIES TO DUKE POWER AT MARKET PRICES. THE NORTH CAROLINA UTILITIES COMMISSION AND THE PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA NOT ONLY REGULATE THE ALLOCATION OF COSTS BETWEEN DUKE POWER AND MILL POWER, BUT THEY ALSO ELIMINATE FOR RATEMAKING PURPOSES FROM

Duke Power's cost of service any profit earned by Mill Power on such transactions. The North Carolina and South Carolina commissions would continue to regulate such transactions effectively even if the Holding Company Act were to be repealed and Duke Power were to reorganize into a holding company system.

In addition to the dramatic changes in the structure of the industry brought about by the Holding Company Act and the evolution of utility regulation at the state level from its formative stages into the strong, comprehensive regulatory systems that exist today, there are two other significant factors referred to by Chairman Shad in his letter that merit additional discussion. The first concerns the disclosure requirements of the Securities Act of 1933 (33 Act) and the reporting requirements of the Securities Exchange Act of 1934 (34 Act). The second relates to developments in the accounting profession that have taken place in the last 50 years. These considerations are significant in that virtually all of the questionable practices that led to the passage of the Holding Company Act raised securities and accounting issues. They could be summarized as follows: (1) the "pyramiding" of companies in a holding company system resulted in a highly leveraged capital structure with a relatively small number of people controlling extensive business

ENTERPRISES; (2) INACCURATE AND MISLEADING ACCOUNTING METHODS AND PRACTICES WERE USED TO MAKE INVESTMENTS IN PUBLIC UTILITIES APPEAR MORE ATTRACTIVE; AND (3) HOLDING COMPANIES MANIPULATED THEIR SECURITIES TRANSACTIONS.*

ALTHOUGH PASSAGE OF THE HOLDING COMPANY ACT ACTUALLY OCCURRED AFTER PASSAGE BY THE CONGRESS OF THE 33 ACT AND THE 34 ACT, IT IS QUITE CLEAR THAT THOSE PIECES OF LEGISLATION HAVE PROVED FAR MORE EFFECTIVE THAN ANTICIPATED. FOR INSTANCE, SENATOR BURTON K. WHEELER, THE SENATE FLOOR MANAGER FOR THE HOLDING COMPANY ACT, DISMISSED THE 33 ACT AS MERELY A "PUBLICITY ACT -- A 'TRUTH IN SECURITIES ACT' -- NO MORE THAN THAT." "IT DOES NOT," HE DECLARED, "ACTUALLY CONTROL THE ISSUE OF ANY SECURITIES -- IT IS MERELY DESIGNED TO TRY TO GET THE TRUTH TOLD ABOUT SECURITIES WHICH ARE ISSUED TO THE PUBLIC, SO THAT IF THE PUBLIC HAS THE TIME AND THE ABILITY IT CAN TO SOME EXTENT FIND OUT WHAT IS BEING SOLD TO IT." CONSEQUENTLY, SENATOR WHEELER INSISTED THAT THE HOLDING COMPANY ACT NOT RELY ON THE CONCEPT OF DISCLOSURE, BUT, INSTEAD, ON AN UNPRECEDENTED DIRECT INVOLVEMENT BY THE SEC IN FUNDAMENTAL MANAGEMENT DECISIONS CONCERNING A HOLDING COMPANY'S OPERATIONS.

FOR OBVIOUS REASONS, THERE IS NO NEED FOR ME TO DISCUSS IN DETAIL WITH THIS SUBCOMMITTEE THE FEDERAL SECURI-

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* SEE ANNEX A HERETO.

TIES LAWS. HOWEVER, FOR THOSE WHO ARE NOT EXPERTS, IT IS IMPORTANT TO NOTE THAT THE CONCEPT OF DISCLOSURE TO INVESTORS OF MATERIAL INFORMATION FORMS THE BACKBONE OF OUR SECURITIES LAWS. THE 33 ACT, FOR EXAMPLE, PROVIDES THAT NO COMPANY, INCLUDING PUBLIC UTILITIES, MAY MAKE A PUBLIC DISTRIBUTION OF ITS SECURITIES WITHOUT FIRST FILING A REGISTRATION STATEMENT RELATING TO THOSE SECURITIES WITH THE SEC. THE CONTENTS OF SUCH REGISTRATION STATEMENT MUST CONFORM TO THE SEC'S RULES AND REGULATIONS, AND THE REGISTRATION STATEMENT MUST DISCLOSE ALL INFORMATION NECESSARY TO MAKE AN INFORMED INVESTMENT DECISION.

SIMILARLY, RULES AND REGULATIONS PROMULGATED BY THE SEC PURSUANT TO THE 34 ACT PROVIDE FOR THE CONTINUOUS DISCLOSURE TO AN INVESTOR OF MATERIAL INFORMATION THROUGH A SYSTEM OF PERIODIC REPORTING. FOR EXAMPLE, A COMPANY IS REQUIRED TO FILE CURRENT, QUARTERLY AND ANNUAL REPORTS WITH THE SEC DISCLOSING CERTAIN MATERIAL INFORMATION. SUCH REPORTS MUST ALSO BE FILED WITH EVERY NATIONAL SECURITIES EXCHANGE ON WHICH THE SECURITIES OF THAT COMPANY ARE BEING TRADED. THE SEC ALSO REQUIRES THAT SHAREHOLDERS BE FURNISHED WITH INFORMATION RELATING TO MATTERS ON WHICH THEY VOTE, AND COMPANIES MUST FURNISH SHAREHOLDERS WITH ANNUAL REPORTS CONCERNING THEIR OPERATIONS. SUCH DISCLOSURE UNDER BOTH THE 33

ACT AND THE 34 ACT PROVIDES AN INVESTOR WITH DETAILED INFORMATION ON BOTH THE FINANCIAL CONDITION AND OPERATIONS OF A COMPANY, INCLUDING PUBLIC UTILITY COMPANIES.

ADDITIONAL PROTECTION IS AFFORDED BY THE TRUST INDENTURE ACT OF 1939. THIS FEDERAL LEGISLATION PRESCRIBES CERTAIN STANDARDS FOR INDENTURES AND TRUSTEES OF DEBT SECURITIES SOLD TO THE PUBLIC. THIS STATUTE IS PARTICULARLY RELEVANT TO UTILITIES IN VIEW OF THE LARGE AMOUNTS OF DEBT SECURITIES THAT ARE TYPICALLY SOLD BY THEM. ALSO, VIRTUALLY EVERY STATE NOW HAS SECURITIES OR "BLUE SKY" LAWS THAT REGULATE THE SALE OF SECURITIES IN THAT STATE.

INVESTORS RECEIVE ADDITIONAL PROTECTION DUE TO THE FACT THAT ACCOUNTING STANDARDS AND PRACTICES HAVE CHANGED CONSIDERABLY SINCE THE PASSAGE OF THE HOLDING COMPANY ACT. PUBLIC UTILITIES ARE NOW SUBJECT TO THE UNIFORM SYSTEM OF ACCOUNTS PROMULGATED BY FERC AND TO SIMILAR STRINGENT ACCOUNTING CONTROLS AT THE STATE LEVEL THAT WERE NOT IN PLACE AT THE TIME THE HOLDING COMPANY ACT WAS PASSED. ALSO, THE INDEPENDENCE OF CERTIFIED PUBLIC ACCOUNTANTS IS MUCH GREATER NOW, AND THAT INDEPENDENCE IS VIRTUALLY GUARANTEED BY CURRENT PRACTICE. MOREOVER, IN ADDITION TO THE DETAILED ACCOUNTING RULES AND REGULATIONS SET FORTH BY THE SEC IN REGULATION S-X, ACCOUNTANTS MUST ALSO FOLLOW THE ACCOUNTING PRINCIPLES ESTAB-

LISHED BY THE FINANCIAL ACCOUNTING STANDARDS BOARD. THE SEC AND BODIES IN THE PRIVATE SECTOR ALSO NOW HAVE PROCEDURES FOR MONITORING THE ETHICAL STANDARDS OF THE PROFESSION.

CLEARLY, THE HOLDING COMPANY ACT IS UNNECESSARY IN THESE RESPECTS. FOR IF THE ACT WERE REPEALED, ALL PUBLICLY-HELD UTILITY HOLDING COMPANIES WOULD CONTINUE TO BE SUBJECT TO THE FINANCIAL DISCLOSURE REQUIREMENTS AND OTHER PROVISIONS OF THE FEDERAL SECURITIES LAWS.

MR. CHAIRMAN, IN HIS TESTIMONY CONGRESSMAN TAUZIN ALLUDED TO THE FACT THAT UNLIKE OTHER FEDERAL STATUTES, THE HOLDING COMPANY ACT DIRECTLY INVOLVES THE SEC IN FUNDAMENTAL MANAGEMENT DECISIONS SUCH AS THOSE INVOLVING THE TERMS AND CONDITIONS, METHOD, AND TIMING OF SECURITIES ISSUANCES. MOREOVER, THE ACT ALSO PROVIDES THE SEC WITH BROAD POWERS TO INFLUENCE EVEN MORE WIDE-RANGING MANAGEMENT DECISIONS. AS CHAIRMAN SHAD NOTED IN HIS LETTER:

> THE ACT, HOWEVER, CONTINUES TO HAVE SIGNIFICANT INFLUENCE ON THE FINANCING AND DIVERSIFICATION DECISIONS OF A MUCH LARGER PORTION OF THE INDUSTRY [THAN THE 14 REGISTERED HOLDING COMPANIES]. APPROXIMATELY EIGHTY HOLDING COMPANY SYSTEMS OPERATE UNDER VARIOUS EXEMPTIONS FROM THE ACT, AND MANY UTILITIES MAY BE RELUCTANT TO FORM HOLDING COMPANIES BECAUSE THEY WOULD THEN HAVE TO REGISTER UNDER THE ACT OR QUALIFY FOR AN EXEMPTION. FURTHERMORE, IN THIS TIME OF ENERGY SHORTAGES AND THE RECOGNIZED

> NEED TO DEVELOP NEW ENERGY RESOURCES, THE ACT MAY DETER NON-UTILITIES FROM PARTICIPATING IN COGENERATION PROJECTS OR OTHER SUCH ACTIVITIES BECAUSE OF THE CONSEQUENCES OF BECOMING SUBJECT TO THE ACT.

AS MR. FLOYD W. LEWIS INDICATED IN HIS TESTIMONY, EXEMPTIONS UNDER THE ACT ARE WHOLLY DISCRETIONARY AND MAY BE REVOKED BY THE SEC AT ANY TIME, EVEN ON A RETROACTIVE BASIS. THE CONSEQUENCES TO A UTILITY HOLDING COMPANY OF LOSING AN EXEMPTION UNDER THE ACT ARE VERY SEVERE, INDEED. THIS IS ESPECIALLY TRUE OF COMBINATION ELECTRIC AND GAS UTILITIES THAT COULD CONCEIVABLY BE SUBJECT TO A SECTION 11 SIMPLIFICATION PROCEEDING, RESULTING IN THE FORCED SALE OF EITHER THE ELECTRIC OR GAS UTILITY BUSINESS. SIMILARLY, MANY COMPANIES, INCLUDING PRESENTLY EXEMPT HOLDING COMPANIES, ARE SIMPLY UNWILLING TO COMMIT MATERIAL ASSETS TO MORE PROFITABLE, NON-UTILITY BUSINESSES IF THEY RISK THE RETROACTIVE LOSS OF THEIR EXEMPTION OR THE FORCED DIVESTITURE OF SUCH ASSETS. IN VIEW OF THE OVERWHELMING REGULATORY BURDENS IMPOSED UPON REGISTERED HOLDING COMPANIES, NO UTILITIES WANT TO RISK BECOMING SUBJECT TO REGISTRATION UNDER THE ACT.

MR. CHAIRMAN, YOUR DISTINGUISHED SUBCOMMITTEE HAS ALREADY HEARD TESTIMONY THAT THE UTILITY INDUSTRY IS EXPERIENCING SERIOUS FINANCIAL DIFFICULTIES. YOU HAVE ALSO HEARD THAT THE HOLDING COMPANY ACT NO LONGER SERVES ANY

USEFUL PURPOSE, AND, IN FACT, PRESENTS BARRIERS TO ACTIVITIES THAT COULD PROVIDE BENEFITS TO BOTH INVESTORS AND CONSUMERS. I RESPECTFULLY SUBMIT THAT DIVERSIFICATION BY UTILITIES INTO MORE PROFITABLE, NON-UTILITY BUSINESSES WOULD PROVIDE ECONOMIC BENEFITS TO PUBLIC UTILITY INVESTORS AND CONSUMERS ALIKE AND WOULD RESULT IN A BETTER OVERALL FINANCIAL CONDITION FOR THE INDUSTRY, WITH ATTENDANT BENEFITS TO OUR NATION. THIS COULD BEST BE ACCOMPLISHED BY THE USE OF A HOLDING COMPANY STRUCTURE WITH SEPARATE CORPORATE SUBSIDIARIES FOR THE UTILITY AND NON-UTILITY BUSINESSES. THIS STRUCTURE WOULD FACILITATE EFFECTIVE STATE REGULATION OF THE UTILITY BUSINESS, MINIMIZE THE POSSIBILITY OF ANY LOSSES OR LIABILITIES TO THE UTILITY AND ITS RATEPAYERS, PREVENT CROSS-SUBSIDIZATION AND FACILITATE THE RAISING OF CAPITAL ON MORE REASONABLE TERMS, THUS BENEFITING RATEPAYERS.

THIS SUBCOMMITTEE HAS PREVIOUSLY HEARD TESTIMONY FROM MR. CHARLES BENORE THAT THE HOLDING COMPANY ACT IS HURTING THE UTILITY INDUSTRY'S FINANCIAL PERFORMANCE BY PROVIDING SIGNIFICANT IMPEDIMENTS TO DIVERSIFICATION. ADDITIONAL EVIDENCE ON THIS POINT IS FOUND IN THE ECONOMIC STUDY PREPARED BY THE CABOT CONSULTING GROUP THAT WE HAVE PREVIOUSLY FURNISHED THE SUBCOMMITTEE STAFF. MR. BENORE ALSO INDICATED THAT HE WAS MORE COMFORTABLE WITH THE STOCKS OF DIVERSIFIED

UTILITIES BECAUSE OF THE ADDITIONAL PROFIT OPPORTUNITIES THAT THE DIVERSIFIED OPERATIONS PRESENTED; HE ALSO SUGGESTED THAT UTILITY EXECUTIVES WERE CAPABLE OF MANAGING A DIVERSIFIED COMPANY AND THAT, ON BALANCE, THE HISTORICAL EXPERIENCE OF DIVERSIFIED UTILITIES HAS BEEN QUITE GOOD. IN HIS TESTIMONY, CONGRESSMAN CORCORAN QUOTED THE CABOT STUDY, "DIVERSIFICATION, A BUSINESS OPTION AND NORMAL PRACTICE IN MOST INDUSTRIES, CAN SELECTIVELY HELP INCREASE EARNINGS OR DECREASE RISK AND MAY IMPROVE THE ATTRACTIVENESS OF BOTH ELECTRIC AND GAS UTILITY SECURITIES AS A RESULT." CONGRESSMAN CORCORAN ALSO NOTED THAT DIVERSIFICATION WOULD FACILITATE THE RAISING OF CAPITAL FOR THE UTILITY AND THUS REDUCE COSTS TO THE RATEPAYER.

MANY OTHERS IN THE INVESTMENT COMMUNITY ALSO BELIEVE THAT DIVERSIFICATION COULD PROVIDE BENEFITS TO INVESTORS AND CONSUMERS ALIKE. MORGAN STANLEY & CO. INCORPORATED, FOR EXAMPLE, RECENTLY SUGGESTED TO A NARUC COMMITTEE THE FOLLOWING REASONS FOR A UTILITY TO DIVERSIFY. I WOULD LIKE TO SHARE THEM WITH YOU NOW:

> 1. TO EARN A HIGHER RATE OF RETURN THAN AVAILABLE IN THE UTILITY BUSINESS, AND THEREBY INCREASE EARNINGS PER SHARE AND MARKET-TO-BOOK RATIOS.
>
> 2. TO ENHANCE INVESTMENT COMMUNITY IMAGE, INCREASE P/E [PRICE/EARNINGS] RATIOS, AND OVER TIME TO PRODUCE A LOWER COST OF CAPITAL.

3. To provide another base of earnings to reduce the risk associated with exposure to a single line of business.

4. To ensure availability of raw materials (and product markets) through vertical integration.

5. To obtain maximum utilization of a company's existing strengths or assets.

Mr. Chairman, if I may summarize some of the testimony on diversification that the Subcommittee has already heard, there are two significant points. First, it should be clear that successful diversification using a holding company structure would facilitate capital formation by making the holding company's securities more attractive to investors, resulting in a lower cost of capital for the utility's ratepayers. Secondly, diversification could actually reduce risk levels over those of utility companies that remain only in the utility business.

Mr. Chairman, I would now like to spend a few moments talking specifically about Duke Power Company. As I indicated at the beginning of my testimony, Duke Power Company does business in both North and South Carolina. As such, if Duke Power were to form a holding company as the preferred structure for any diversification activities, it would have to register as a registered holding company under the Act since Duke Power would not qualify for one of the

EXEMPTIONS PRESENTLY CONTAINED IN SECTION 3 OF THE ACT. FOR MANY OF THE REASONS YOU HAVE HEARD, DUKE POWER SIMPLY WOULD NOT FORM A HOLDING COMPANY UNDER THESE CIRCUMSTANCES. YET, WE BELIEVE THAT A HOLDING COMPANY STRUCTURE WOULD BE THE PREFERABLE FORM OF CORPORATE STRUCTURE FOR US TO USE IN ORDER TO ACHIEVE OUR LONG-TERM CORPORATE GOALS.

DUKE POWER COMPANY'S MAJOR CORPORATE OBJECTIVE IS, AND WILL CONTINUE TO BE, TO EXCEL AS AN ELECTRIC UTILITY -- TO PROVIDE HIGH QUALITY ELECTRIC SERVICE TO CONSUMERS AT AFFORDABLE PRICES WHILE AT THE SAME TIME EARNING A COMPENSATORY RETURN FOR ITS INVESTORS. WE HOPE, HOWEVER, TO ENHANCE OUR COMPANY'S EXCELLENCE BY FULLY DEVELOPING ITS DEMONSTRATED TALENTS AND EXPANDING THEM, AS APPROPRIATE, INTO NON-REGULATED MARKETS. THESE EFFORTS WILL BE SERVICE-ORIENTED, NOT CAPITAL INTENSIVE, AND THEY WILL UTILIZE EXPERTISE AND NON-UTILITY ASSETS DESIGNED TO PROVIDE SYNERGISTIC BENEFITS TO OUR CORE ELECTRIC UTILITY BUSINESS.

FOR EXAMPLE, DUKE'S WHOLLY-OWNED SUBSIDIARY, CRESCENT LAND AND TIMBER CORP., OWNS APPROXIMATELY 270,000 ACRES OF NON-UTILITY LAND. FOR YEARS CRESCENT HAS CONDUCTED FORESTRY AND LIMITED RECREATIONAL LAND DEVELOPMENT ACTIVITIES. AT THE PRESENT TIME, IT IS INVOLVED IN DISCUSSIONS WITH A MAJOR TEXTILE FIRM IN OUR SERVICE TERRITORY CONCERNING

THE POSSIBILITY OF UTILIZING WOOD CHIPS AS A NEW SOURCE OF ENERGY, POSSIBLY FOR THE CO-GENERATION OF ELECTRICITY. CRESCENT HAS ALSO RECENTLY ENGAGED THE SERVICES OF A GEOLOGICAL CONSULTING FIRM TO DETERMINE IF ITS LAND CONTAINS OTHER NATURAL RESOURCES THAT COULD BE PROFITABLY EXPLOITED.

AS I HAVE MENTIONED, MILL POWER SUPPLY COMPANY, ANOTHER SUBSIDIARY, HAS BEEN IN THE ELECTRICAL EQUIPMENT BUSINESS FOR 72 YEARS. IT WAS ORIGINALLY ESTABLISHED TO MARKET EQUIPMENT TO ENABLE INDIVIDUAL BUSINESSES TO CONVERT FROM WATER POWER TO ELECTRIC ENERGY, AND OVER THE YEARS MILL POWER HAS EXPANDED ITS BUSINESS TO INCLUDE OTHER FORMS OF MAJOR ELECTRICAL EQUIPMENT. WE BELIEVE THAT IN THE FUTURE MILL POWER SHOULD BE EFFECTIVELY POSITIONED TO MARKET DEVELOPING ENERGY AND CONSERVATION TECHNOLOGIES. IN THIS REGARD, MILL POWER COULD PROVIDE SYNERGISTIC BENEFITS FOR DUKE POWER'S LOAD MANAGEMENT PROGRAM. ANOTHER COMPANY IN OUR AD HOC GROUP, PACIFIC LIGHTING CORPORATION, WHOSE SOUTHERN CALIFORNIA GAS COMPANY IS THE LARGEST GAS DISTRIBUTOR IN THE UNITED STATES, HAS ALSO DIVERSIFIED INTO ENERGY CONSERVATION AREAS AS PART OF ITS LONG-TERM STRATEGIES. FOR EXAMPLE, ITS DUAL FUEL SYSTEMS SUBSIDIARY MANUFACTURES AND MARKETS EQUIPMENT THAT ENABLES VEHICLES TO OPERATE ON COMPRESSED NATURAL GAS INTERCHANGEABLY WITH

GASOLINE. ALSO, ANOTHER SUBSIDIARY OF PACIFIC LIGHTING IS DEVELOPING A SCRUBBER SYSTEM THAT CLEANS AND UPGRADES THE QUALITY OF "WASTE" BIOGAS PRODUCED FROM SEWAGE AND LANDFILLS. INCREASED ENERGY CONSERVATION IS, OF COURSE, ONE NECESSARY ELEMENT IN OUR NATION'S ENERGY FUTURE.

FINALLY, DUKE POWER'S DESIGN ENGINEERING AND CONSTRUCTION TEAM, SOME 8,000 STRONG, HAS DEVELOPED A UNIQUE CAPABILITY IN OUR INDUSTRY. IT DESIGNS AND CONSTRUCTS, IN-HOUSE, ALL OF DUKE POWER COMPANY'S POWER PLANTS. THESE PLANTS ARE THE MOST EFFICIENT IN THE INDUSTRY. AS DUKE POWER'S NEED FOR NEW CONSTRUCTION DECLINES, ITS DESIGN ENGINEERING AND CONSTRUCTION CAPABILITY COULD BE MADE AVAILABLE TO OTHERS. FOR EXAMPLE, OUR DESIGN ENGINEERING AND CONSTRUCTION TEAM HAS ALREADY UNDERTAKEN AS A PILOT PROJECT THE DESIGN OF A NUCLEAR WASTE DISPOSAL FACILITY FOR ANOTHER UTILITY AND IS EXPLORING OTHER SIMILAR OPPORTUNITIES.

THESE ARE EXAMPLES OF THE KINDS OF DIVERSIFIED ACTIVITIES DUKE POWER PLANS TO PURSUE IN FURTHERANCE OF ITS LONG-TERM CORPORATE STRATEGIES. THEY ARE COMPATIBLE WITH THE CORE UTILITY BUSINESS, BUILDING UPON IT WITHOUT REQUIRING A LARGE INFUSION OF CAPITAL, A BASIC CHANGE IN MANAGEMENT STYLE, OR A UNIQUE KIND OF EXPERTISE. MOREOVER, WE BELIEVE THAT THE INTERESTS OF BOTH INVESTORS AND CONSUMERS WOULD BE MAXIMIZED

IF WE WERE TO UTILIZE A HOLDING COMPANY STRUCTURE FOR SUCH ACTIVITIES. WHILE I CANNOT SPEAK FOR OTHER UTILITIES, IT IS MY BELIEF THAT THEY WOULD PURSUE A SIMILAR COURSE IN SEEKING OPPORTUNITIES FOR DIVERSIFICATION.

MR. CHAIRMAN, I RESPECTFULLY URGE THE SUBCOMMITTEE TO REMOVE THE UNNECESSARY REGULATORY BURDENS THAT THE HOLDING COMPANY ACT IMPOSES ON THE ELECTRIC AND GAS UTILITY INDUSTRY. I WOULD ALSO LIKE TO REPEAT A POINT MADE BY CONGRESSMAN CORCORAN IN THE CONCLUSION OF HIS TESTIMONY, "DIVERSIFICATION IS NOT A PANACEA NOR THE SOLE SOLUTION TO THE CONTEMPORARY FINANCIAL PROBLEMS OF THE INDUSTRY OR ITS RATEPAYERS. BUT, IN AN ECONOMY WHERE REGULATED UTILITIES MUST COMPETE IN THE CAPITAL MARKETS WITH UNREGULATED INDUSTRIES AND THE FEDERAL GOVERNMENT FOR LIMITED AMOUNTS OF CAPITAL, DIVERSIFICATION REPRESENTS ONE INNOVATIVE MANAGEMENT TECHNIQUE THAT COULD BE USED BY THE INDUSTRY TO FACILITATE CAPITAL FORMATION AND, THUS, ITS LONG-TERM SURVIVAL."

MR. CHAIRMAN, I WOULD LIKE TO THANK YOU FOR THE OPPORTUNITY TO TESTIFY TODAY. THIS CONCLUDES MY PREPARED REMARKS.

ANNEX A

(1) Pyramiding companies owning or controlling the operating companies for the purpose of enabling a minimum of investment to control a maximum of operating facilities, involving a greedy and highly speculative type of organization detrimental to the financial and economic welfare of the Nation.

(2) Loading the fixed-capital account of public utilities with arbitrary or imaginary amounts in order to establish a base for excessive rates.

(3) Writing up the fixed assets without regard to the cost thereof, with the result of watering the stock or creating a fictitious surplus.

(4) Engaging in transactions of purchase and sale of property or securities with controlled or subsidiary companies for the purpose of recording arbitrary profits or fixing valuations unjustified by market values.

(5) Exaction of payments from affiliated or controlled companies for services in excess of cost or value of such services.

(6) Gross disregard of prudent financing in excessive issues of obligations, imperiling the solvency of the company and involving excessive charges for interest, discount, commissions, redemption, etc.

(7) Manipulating the security markets to deceive stockholders, bondholders, or potential purchasers of its securities.

(8) Putting funds in the call-loan market with the result of greatly stimulating speculation.

(9) Excessive use of conversion privileges for bonds and preferred stocks and of purchase warrants and

options with the effect of inducing investors to part with conservative investments for speculative ones.

(10) Misstatement of earned surplus, or failure to distinguish earned from capital surplus, and making payment of dividends from the latter.

(11) Deceptive or illusory methods of dividing, or pretending to divide, earnings or profits.

(12) Including imaginary (or "putative") interest in construction costs of a public utility and counting it as a part of earnings.

(13) Deceptive or unsound methods of accounting for assets and liabilities, costs, operating results and earnings, including write-ups, unrealized or fictitious profits, stock dividends, etc.

(14) Corporate organization which gives powers inconsistent with a just division of responsibilities and emoluments as between various groups or parties furnishing capital by loan or by contribution, either directly or indirectly by purchase, succession, or otherwise.

(15) Issuing special voting or management stock giving control at small cost in order to promote the interests of selfish cliques, against the interest and safety of the general stockholders.

(16) Unsafe or mischievous methods of securing loans to the detriment of the lender.

(17) Intercompany financing on a basis disadvantageous to operating company borrowers or lenders.

(18) Evasion of State laws in effecting sales of security issues.

(19) Effecting pretended corporate reorganizations principally for the purpose of evading the payment of Federal income taxes.

Senator D'AMATO. Thank you very much, Mr. Grigg.

I notice that each of the associations—or each of you are associated with a group of companies. You represent segments of the utilities industry and share similar concerns or are similarly situated. The three groups were instrumental in drafting three bills I introduced last fall for the purpose of initiating debates on these issues to try to crystalize some of the points of concern both from point of view of the industry and that of people who might see the issues from the regulatory side and the consumers' side. I would like each of you to speak briefly to the provisions of the bill drafted by and for your group in conjunction with our staff.

I'll start it off with Mr. Nichols. In particular, I am interested in S. 1869, and the effect of specific changes in the act as contrasted by your testimony today in favor of total repeal. I'd like you to speak to the effect of S. 1869 as opposed to outright repeal.

EFFECT OF CHANGES IN THE ACT

Mr. NICHOLS. Yes; I am pleased to have the opportunity to do so because our group of eight registered electric utility holding companies started off by looking at the act to see whether we could make changes that would make the act more reasonable from the viewpoint of investors, as well as ratepayers.

Senator D'AMATO. By the way, let me share a concern publicly for the record. I notice that it doesn't change—it's not too much different from a situation in which you're representing a private client who at first comes in and says, "My gosh, save me, I'm in danger of litigation", or some regulator is going to make it most difficult, and the client is willing to go to the greatest lengths either to settle that suit or dispose of that matter.

One counsel comes back and says, "We have in hand a settlement", but the client thinks that's not quite enough. How about getting a little bit more? Then we go a little bit further, and then we get some outside counsel who suggests that he could have even done greater things for the client. Similarly we go from regulatory reform addressing the specifics that Mr. Tankersley described, in terms of impediments to business efficiency and management, to an effort to get rid of the whole kit and caboodle. Efforts to repeal the act might be the catalyst that brings about a storm of protest, rather than amendments dealing very specifically with those problems that we can all recognize and that reasonable people on both sides of the aisle can agree upon.

Amending rather then repealing the act may not give to all of those here a complete victory, but the entire ballgame may not be won and there may be no solace as a result of an all-out assault on the Public Utility Holding Company Act.

I leave that to you. Those experienced in the regulatory process know well the furor that can take place, even though it may seem to you an innocuous matter. I think repeal is viewed by many as a real assault on the consumer and the taxpayer.

I'll say one other thing, Mr. Nichols. You have done a magnificent job in summarizing some of the questions that I have put to other panelists at our previous hearings. You responded in terms of the questions of April 27, No. 1 and No. 3, but you skipped No. 2.

Mr. NICHOLS. If I can find my list of questions now, I will go to No. 2, if you like. Would diversification result in a diversion of management attention and resources that should be devoted to the utility business? And the answer is: Absolutely not. I can think of a whole series of reasons why——

Senator D'AMATO. That sets up the debate. [Laughter.]

Mr. NICHOLS. Let's just think for a minute about the electric utility business. It's a huge money business. The system I represent comprises just under 1 percent of the entire industry, yet we have assets well in excess of $2 billion, revenues in excess of $1 billion a year. So whether the electric utility operation is part of a much diversified organization or not, it is such a huge money operation it is bound to get the attention it has to have because of the impact of those massive numbers of dollars. We have been partially diversified for a number of years. Yet, over 90 percent, over $2 billion of our assets are still devoted to the electric utility business, and over 90 percent of our earnings, something in excess of $80 million a year are still associated with that end of the business.

SIGNIFICANT BENEFITS TO MANAGEMENT

Let me also mention that diversification brings significant benefits to the management of an electric utility company. I would like to ask you to think about the problems of managing what is, by design, a very low growth operation. We know it's in our customers' best interest to pursue energy conservation. The faster we have to bring on new plants the higher our rates have to go, because new plants cost more than the old ones. For that reason, our electric operation is, by design, low growth. And I ask you to think about the problems of trying to attract and keep good people to a no-growth or low-growth operation. It is very difficult.

Since we have been diversified I can assure you we have been able to attract much better people into our entire organization. And, by the way, we rotate them through different corporations within our holding company system to get the benefits of that training. And, a lot of the benefits that have been learned, a lot of the lessons learned by our people in the diversified businesses are transferrable. I honestly believe we have a tougher, more aggressive, more determined group of managers on the electric side of our business that do a better job for our ratepayers because we are diversified. So I do not, in any way, think that you will get a diminution of management attention on the electric side. You will improve it.

Senator D'AMATO. How does the industry respond to the claims of the plumbing, heating, air-conditioning industry that the electric utility entry into these markets, as well as conservation, may be anticompetitive and create a monopoly as a result of their monopoly power and their substantial assets, to the disadvantage of the unregulated competitors?

Mr. NICHOLS. Once again, 80 percent of our industry now has the freedom to go into those businesses if those companies would like to, and it's only the registered electric companies on the electric side that are barred from that at the present time. But No. 2, I would comment that other existing laws address this issue very directly. The Public Utility Holding Company Act of 1935 is not an antitrust or procompetition statute. Other statutes now on the books adequately protect their interests.

Finally, it's my own personal experience that we haven't been very successful in small, labor-intensive businesses. I don't think that we, as far as our system is concerned, are going to give the plumbers a very hard time. I think they might give us a very hard time, but I don't think that that question is germane to repeal of the Public Utility Holding Company Act because the protection that they are looking for already exists under other statutes and is not present in the 1935 act, in any case.

Senator D'AMATO. I would like for Mr. Grigg and Mr. Tankersley to respond to my initial question, in terms of repeal versus some of the specific amendments that your associations and groups have worked with us in developing. Why should Congress repeal the act, rather than simply dealing with these unnecessary burdens which you have identified—is it because the Administration and the SEC support repeal? When do you find a Commission saying it is willing to give up jurisdiction? That's an incredible thing, particularly in Washington.

Mr. TANKERSLEY. Mr. Chairman, speaking from a gas company, it's one of the few times I think I've ever agreed with everything an electric company man said. [Laughter.]

But if you know in our—let's say the bill S. 1871 that represents the three gas companies' interests, it's a very simple bill in that it rather amends ourselves out of the act by simply saying if you're subjected to the Securities Act of 1933 and the Securities Exchange Act of 1934, and are subject to public utility commissions in the states you operate, you then are not subject to the Public Utility Holding Company Act.

Senator D'AMATO. Would you be happy with that bill?

Mr. TANKERSLEY. Yes, I would be happy with that bill. That still keeps the Holding Company Act on the books, and that is really the problem. We have all alluded to the consumer side, we've alluded to the ratepayer's side.

If I may, Mr. Chairman, I think it would be helpful to read two sentences into the record. I think it would help the record on your earlier question having to do with the public service ability to handle diversifications. This is a statement by Mr. Luther Heckman, who was chairman of the Ohio Public Utilities Commission, in testifying before the National Association of Regulatory Utility Commissioners, two sentences. I quote:

> I believe repeal of the 1935 act will have absolutely no impact on the ability of rate regulators to effectively deal with the phenomenon of utility diversification. Indeed, as a regulator, I am unaware in any manner in which the 1935 act made my task in dealing with diversification issues, such as those noted in the draft report, any less complicated or any more effective.

A number of utilities operate in Ohio, and one of our largest is there—Mr. Heckman retired from the commission in 1980, so that's not a statement made quite some time ago.

Senator D'AMATO. Let me ask you, Mr. Tankersley, is there any basis for distinguishing between electric utilities and gas utilities in evaluating whether or not there is a continuing need for the Holding Company Act's regulatory requirements?

Mr. **Tankersley**. No; I'm not aware of any. There are differences, material differences in the two operations, but I am not sure that I could specifically say we should be out and they should be in.

Senator D'**Amato**. What a wonderful consensus we have identified. [Laughter.]

Mr. Grigg?

Mr. **Grigg**. Mr. Chairman, our group, which I identified at the outset of my remarks, has felt from the beginning that repealing the act was justified. We think it served its purpose and it's not going to be useful. Frankly, we have been associated more, I suppose, with S. 1870, because we didn't want to get involved in the holding company's pea patch. We didn't want to catch that disease.

Until they came forward and indicated their support for repeal, we were interested in a much more limited change in the act, which is reflected in S. 1870. That would do two things. It would add a new section 3(a)(6) which would exempt holding companies with only one public utility subsidiary operating in its State of incorporation and in States contiguous thereto. That's Duke Power Co. We're incorporated in North Carolina. We operate in the two Carolinas. If we became subject—we became a part of a holding company, we would be exempt. We are not now eligible for an exemption because we are interstate. In effect, it expands the intrastate exemption to cover operations within contiguous States and is thus consistent with the philosophy of the act that public utilities ought to be confined to specific geographical areas amenable to effective State regulations, so we think it's consistent with that philosophy.

A second provision provides that if the holding company presently qualifies for an exemption—take Commonwealth Edison in Chicago, for example. It's an exempt holding company because the parent itself is an electric operating utility. It owns a small generating company in an adjacent State.

The second exemption or second provision would also exempt Commonwealth Edison if it were to become part of a holding company structure, a subsidiary in a holding company structure. In other words, just simply retain the exemption it already had.

The third provision would make all exemptions unqualified, because we think, one——

Senator D'**Amato**. You think that's very important?

Mr. **Grigg**. Mr. Chairman, we do, because the SEC, as I said in my prepared remarks, under a vague standard, really is almost no standard at all, can revoke an exemption and apply that revocation retroactively, and the results can be very severe. That's a risk very few managements, I think, would be willing to undertake, although some have.

Senator D'**Amato**. If we amended that provision that would be a substantial improvement, in terms of giving to management flexibility which they might have now, but which they may be hesitant to utilize as a result of the unknown, the uncertainty; is that right?

Mr. **Grigg**. That's probably a fair statement.

Mr. Nichols?

Mr. **Nichols**. Yes; I do represent a group of eight of the registered electric holding companies. We have been discussing possible relief from the act for over 2 years now. In our original discussions, we came up with an outline of an act that perhaps is easiest to describe from the viewpoint of what it preserves for the SEC. Our outline, which was incorporated in S. 1869, would have significantly relaxed the act with respect to both diversification and control of financing. But it would preserve the SEC's authority to intercede, to preclude a financing which presents an unreasonable risk to investors or ratepayers, which the SEC would have to define as an unsound financial practice.

It would also preserve the SEC's responsibility to approve an acquisition of utility assets or a 5 percent interest in the securities of another utility. It would preserve SEC's authority to compel a divestiture of a business interest which is material and detrimental to the interests of investors or ratepayers, and they would have to make that finding.

Senator D'Amato. Could we stop right there? Please, say it again.

Mr. Nichols. It would preserve SEC authority to compel a divestiture of a business interest which is material and detrimental to the interests of the investors or ratepayers. The utility and the SEC would have to make that finding.

Senator D'Amato. On that point, can't we rather effectively deal with the arguments of those who have expressed very real concerns about the impact of diversification on consumers, ratepayers, et cetera, by preserving the SEC's authority to deal with problems of mismanagement, whatever you might want to call it, in activities outside of the traditional utility business? Don't we go a long way toward answering those fears that some have expressed to this committee, and continue to express

Mr. Nichols. I think that is a less than optimum solution, but, certainly, it would go a long way in the area you suggest. I think the real question is: Is it necessary to take that step? And I would argue that it is not because, remember, 80 percent of our industry can now get into these businesses of their own volition.

Senator D'Amato. But they don't because of the problem that Mr. Grigg described.

Mr. Nichols. Excuse me, they do get into the businesses, but they do not do it in a way that is optimum from the viewpoint of the ratepayer. We are diversifying as an industry. In fact, over two-thirds of the electric companies of the country are now involved in diversified operations.

I would suggest, and Mr. Grigg pointed this out as well, that from the rate regulatory viewpoint, and from the ratepayers' viewpoint, the public utility holding company corporate structure is the optimum structure within which to diversify, because it is the structure that permits the easiest collection of accurate costs. Therefore, I don't really think that we want to in any way discourage the utilities from using that optimum structure. And if you preserve this particular point in this fashion, I think you do just that.

Senator D'Amato. Is the SEC the right agency to administer the act? Could FERC undertake this responsibility?

Mr. Nichols. The choice between the frying pan and the fire is never an attractive choice. [Laughter.]

I would hope that such a preservation isn't necessary. If it is necessary, this would be a more livable one than our present setup.

Senator D'Amato. What would be a more livable system?

Mr. Nichols. The approach spelled out in S. 1869. It is, certainly, far preferable to the types of control exerted under the present act. But if I may mention just a fifth and final preservation in S. 1869, it preserves SEC control over affiliate transactions, although the SEC would be given greater flexibility to depart from the statutory cost standard in appropriate cases.

So those five preservations of authority describe the activities of the SEC if S. 1869 were passed. I would have to say that while S. 1869 is a large step in what I would consider to be the right direction, it is not the optimum step. Since our original thinking on this subject there has been so much more work on the issue, including the Cabot study and others, I would therefore like to suggest that the optimum approach is repeal of the act.

Senator D'Amato. Mr. Tankersley, I noticed that you wanted to comment. [Laughter.]

Mr. Tankersley. I think we have adequately covered that point. It had to do with the Public Utility Commission's ability to do their job under the diversification problem.

I would like to point out if we make one bad law to correct one old law, I don't think that we have gone too far. In the diversification side, one of the very real problems, one I pointed out; that is, the 25-day notice period, where if you want to buy a company that is completely all right with the SEC you have to give a 25-day notice. You spell out who you are buying, what price you are going to pay, and then one of our friends who are not subject to the act can come in and bid a little bit higher price in that 25-day period.

Those types of things are the problems in the diversification under the act and ones that are going to have to be corrected before we can move ahead in any meaningful way for those companies that want to diversify.

Senator D'Amato. I made notes specifically on those issues that you mentioned restrictions on financing for example and the requirement of public bidding. Limitations on selection of directors, such as bankers, notice requirements to the SEC, onerous burdens for ordinary business transactions, and I would suggest that we deal with those issues by amending the act in areas that reasonable people can agree upon. I would hate to see us get into a situation where we get no relief as a result of looking for total relief.

I would also suggest that as a bargaining position, quite candidly, I would suggest to you, keep pushing for total relief but be willing to settle for less than total relief. [Laughter.]

I want to thank this panel for the very, very careful presentations, well thought out, well articulated, your response not only to me at this particular hearing, but throughout this process. I look forward to our continuing dialog as we consider this matter which is important to the industry and to the American consumer, the public. They may or may not be aware of it. To be quite candid with you, it is not the most exciting subject. [Laughter.]

I do not go on speaking tours to talk about it. Imagine me bringing up the PUHCA Act; the audiences would be less than enthusiastic. As a matter of fact, I spoke to a group who were quite knowledgeable about it just the other morning, and let me tell you, they all went to sleep.

But I thank you very much for your participation.

Mr. GRIGG. May I say, Mr. Chairman, that was not the report that we got from your presentation.

Senator D'AMATO. You could run for public office.[Laughter.]

Mr. TANKERSLEY. Mr. Chairman, for the record could I ask that Mr. Heckman's and Mr. Dunham's testimony which has been filed be incorporated in the record.

Senator D'AMATO. It will be incorporated into the record in its entirety.

[The complete statements follow:]

Testimony of
C. Luther Heckman, Esq.
Porter, Wright, Morris & Arthur
Columbus, Ohio

June, 1982

Before the
Senate Committee on Banking, Housing & Urban Affairs
Securities Subcommittee

Mr. Chairman, Committee Members, Ladies and Gentlemen:

My name is C. Luther Heckman. I am an attorney, and partner in the firm of Porter, Wright, Morris and Arthur of Columbus, Ohio and Washington, D.C. I appear before you today on behalf of Consolidated Natural Gas Company, the Columbia Gas System, and National Fuel Gas Co.

Prior to entering private law practice, I served as Chairman of the Public Utilities Commission of Ohio from 1975 to 1980. The Public Utilities Commission of Ohio has jurisdiction over the rates, finances, operations and service of natural gas, electric, telephone and transportation utilities. During my tenure on the Commission, I served on the Executive Committee of the National Association of Regulatory Utility Commissioners, and was President of the Great Lakes Conference of Public Utilities Commissioners. I also served on a task force advising the Federal Power Commission (now the Federal Energy Regulatory Commission) on natural gas regulation. Prior to my appointment to the Commission, I served as Majority and Minority Counsel to the Ohio House of Representatives, and as an Assistant Ohio Attorney General. A substantial portion of my current legal practice is devoted to public utility law.

I would like to thank the members of the Subcommittee for giving me the opportunity to testify today on S.1871, which would amend the Public Utility Holding Company Act of 1935 to exempt from its requirements gas utility holding companies which are regulated under the Securities Exchange Act of 1934, and which have subsidiaries whose intrastate rates are subject to regulation by State authorities. My testimony addresses the extent to which the powers of the SEC under the 1935 Act are duplicative of the powers currently held and exercised by state regulatory commissions under state law, and the impact of the proposed legislation on the scope of state regulation.

I. HISTORICAL BACKGROUND

The Public Utility Holding Company Act of 1935 was enacted in large part because of the perceived inability of states to control the activities of the large utility holding company systems. Not all states regulated the activities of public utilities, and those that did regulate utility operating companies found it impossible to control, directly or indirectly, the activities of the holding companies.[1] Moreover, state regulation of utility operating companies had not been successful in coping with such abuses as inflated asset and security values; excessive charges for transfers of assets or services between parent and subsidiary; Byzantine accounting practices; inequitable allocation of costs among subsidiaries in different jurisdictions; irrational and inefficient corporate structures; and inadequate utility service. The inability or unwillingness of state authorities to deal with these abuses convinced Congress of the need for federal regulation.[2]

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[1] Attempts at direct controls were often found to be an unconstitutional interference with interstate commerce. See, e.g., Missouri v. Kansas Natural Gas Co., 265 U.S. 298 (1924). Indirect control was difficult because holding companies were usually foreign corporations, beyond the reach of state jurisdiction, see, e.g., Publ. Util. Comm. v. Romberg, 275 Ill. 432, 114 N.E. 191 (1916); Toledo Light, Traction & Power Co. v. Smith, 205 Fed. 643 (N.D. Ohio 1913); or were not "public utilities" as defined in state statutes. Lilienthal, The Regulation of Utility Holding Companies, 29 Col. L. Rev. 404, 409 (1929).

In the forty-seven years since Congress passed the 1935 Act, the scope and sophistication of state utility regulation has changed dramatically. State public utility commissions generally have specific statutory authority to act in the areas of abuse outlined by Congress when it passed the 1935 Act, and have the resources and competence to exercise that authority. The evolution of constitutional law concerning the interstate impacts of state regulation, and the extension of state jurisdiction over the activities of foreign corporations which have an impact within a state, have removed any Federal Constitutional impediments to effective state regulation of foreign holding companies whose public utility subsidiaries provide service within the state. In short, state regulatory commissions are now fully capable of performing the tasks performed by the SEC under the 1935 Act.

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[2] The inability of state regulation to deal with these abuses is specifically cited in Section 1(b) of the Act, 15 U.S.C. §79a(b) (1976).

II. SCOPE OF STATE REGULATION

In sharp contrast to the conditions prevailing in 1935, state regulatory commissions wield powers over public utility operating companies and their nonjurisdictional affiliates which are more than sufficient to prevent the abuses which motivated Congress to pass the 1935 Act.

A. Intercompany Transactions

Unlike the situation prevailing in 1935, state commissions now generally have ample powers to prevent intercompany transactions within a holding company system which unfairly burden the jurisdictional operating company or its consumers. There is no longer any question that state authorities can assert jurisdiction over an affiliate of a jurisdictional operating company for the purpose of gaining access to its accounts and records and compelling the submission of reports of affiliate transactions.[3] Most states have enacted legislation requiring extensive reporting of affiliate transactions, the approval of certain intercorporate contracts or arrangements, and imposing upon the utility the burden of proving the reasonableness of these transactions.[4]

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[3] Natural Gas Pipeline Co. v. Slattery, 302 U.S. 300 (1937).

[4] See, e.g., N.Y. Pub. Serv. Law §§110(2); 110(3); 16 NYCRR §§292.12, 310.1(5)(i), 311.14, 320.1(2), 321.7; W. Va. Code §24-2-12(F) (1980); Ohio Rev. Code §§4905.05, 4905.16, 4905.48; 66 Pa. Cons. Stat. Ann. §§2102, 2103, 2105.

B. Issuance of Securities

The evils which Congress sought to remedy in connection with the issuance of securities by utility companies can now be effectively prevented by state authorities. State public utility commissions generally require the approval of the issuance of securities by utilities. The scope of review usually extends to the terms of the offering, the financial condition of the applicant, and the application of the proceeds.[5]

C. Accounting and Disclosure

In contrast to the situation prevailing in 1935, state laws now require public utilities to follow uniform accounting procedures. With respect to gas utilities, most states require conformity to the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission.[6] Other commissions have prescribed their own comprehensive systems of accounts.[7]

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[5] See, e.g., N.Y. Pub. Serv. Law §69; 16 NYCRR §§37,245; Ohio Rev. Code §§4905.40, 4905.41, 4905.42; 66 Pa. Cons. Stat. §§1901, 1902, 1903, 1904.

[6] See, e.g., W. Va. Gas Utilities Rule 2.01(1); Rule 4901:1-13-04; Ohio Adm. Code; 66 Pa. Cons. Stat. Ann. §1701; 52 Pa. Code §59.42.

[7] See, e.g., 16 NYCRR §§310.0, 320.0

In addition to prescribing accounting procedures, state commissions have authority to inspect and audit utility accounting records, and to require the filing of periodic accounting reports.[8] Other extensive reporting requirements are commonly imposed with respect to such matters as gas purchasing policies and the adequacy of gas supplies.[9]

D. Rate Regulation

In enacting the 1935 Act, Congress was concerned that state regulatory commissions were unable to cope with abuses such as the inflation of the value of assets recorded on utility books, improper allocation of costs among members of holding company systems, and unreasonable charges for services or equipment supplied by affiliates, all of which led to the charging of excessive rates to consumers of utility service.

Only a few states had well-developed schemes of utility rate regulation in 1935. Today, I am unaware of any state commission without the authority to prevent consumers from bearing the cost of improper utility practices such as those leading to the enactment of the 1935 Act.

State statutes generally require the utility to bear the burden of proving the justness and reasonableness of its rates.[10] In fixing rates, utility commissions commonly require the utility to establish the valuation of the property incorporated into rate base, to demonstrate that costs are properly allocated to jurisdictional customers, and to justify the costs of affiliate transactions. Consequently, state regulations have the ability to closely scrutinize intercompany relationships and to prevent any inappropriate impact on consumers' rates.

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[8] See, e.g., 6 NYCRR §§291, 293.1; W. Va. Code §24-2-9; W. Va. Gas Utility Rule 2.03; Ohio Rev. Code §§4905.07; Rule 4901;1-14-07, Ohio Adm. Code; 52 Pa. Code §59.48.

[9] See, e.g., Ohio Rev. Code §4905.15, 52 Pa. Code §59.61(a).

E. Corporate Structure

The pyramiding of utility corporate structures which led to the enactment of the 1935 Act would be virtually impossible under current state laws governing utility mergers, consolidations and the acquisition of utility assets. Most states require regulatory commission approval of the terms of any merger, consolidation or sale of assets. Moreover, many states prohibit one utility to acquire any of the stock, bonds, or other evidence of indebtedness of another utility without regulatory approval.[11]

F. Regulatory Oversight of Utility Operations

In addition to the powers over specific aspects of a utility's business enumerated above, state regulatory commissions generally are vested with broad authority over the totality of a utility's operations. Most state commissions are provided with general authority to investigate the rates, service, and operations of utilities. Some state commissions have ordered extensive management audits of utilities under their supervision, with the scope of the audits extending to relationships with affiliates.

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[10] See, e.g.. Ohio Rev. Code §4909.19; Indiana Code Ann. §8-1-2-73, N.Y. Pub. Serv. Law §66(12).

[11] See, e.g., Ohio Rev. Code §4905.48; Indiana Code Ann. §8-1-2-83, 84; W. Va. Code §24-2-12; 66 Pa. Cons. Stat. §1102.

III. CONCLUSION

Based upon my own experience as a state utility regulator, my extensive work and contact with utility regulators from throughout the United States, and my analysis of representative state laws and regulations, I can, without hesitation, assure you that if the proposed exemption legislation is passed, state utility regulatory commissions have the authority and competence to prevent any abuses which otherwise might occur in the absence of SEC regulation under the 1935 Act. Moreover, I believe that state regulators, who must constantly "take the heat" for their decisions, are more sensitive to the interests of consumers than are federal bureaucrats. In a similar vein, it is my belief that, to the extent existing laws in any jurisdiction may be found to be inadequate to the task of effectively regulating utilities which are part of a holding company system, state legislatures can be counted on to provide regulators with the necessary tools. Given the fact that public utility "reform" is already a potent political issue in most states, I cannot imagine that legislators would be slow to respond with legislation in the event that existing laws prove inadequate to curb abuses which might appear in the absence of federal regulation.

Prepared Statement of Richard L. Dunham before the Subcommittee on Securities of the Senate on Banking, Housing and Urban Affairs

Mr. Chairman, Senators: My name is Richard L. Dunham, president of H. Zinder & Associates, an economic and regulatory affairs consulting company located in Washington, D.C.

From 1975 to 1977, I was a member and Chairman of the Federal Power Commission, now the Federal Energy Regulatory Commission. In 1975 I was Deputy Director of the Domestic Council, and prior to 1975 Director of the Budget of the State of New York.

I appear before you today on behalf of Consolidated Natural Gas Company, the Columbia Gas System and National Fuel Co., the only three natural gas utility holding companies still registered under the Public Utility Holding Company Act of 1935 (The Act). All three of these companies operate interstate gas transmission companies subject to regulation by the Federal Energy Regulatory Commission (FERC) under the Natural Gas Act, enacted in 1938. In addition, all three of these companies own gas distribution utilities which are concentrated mainly in Ohio, Pennsylvania, New York and West Virginia; Columbia also owns gas utilities in Kentucky, Virginia, and Maryland.

All of the gas utilities are regulated by the Regulatory Commissions of the States in which they provide service.

The purpose of my testimony is to support the repeal of the 1935 Act, or other legislation which would free these three companies from the archaic and counterproductive regulations to which they are now subjected by the Act.

The 1935 Act had as its primary objective to regulate or supervise holding company activities which affected both investors and the consumer. The Natural Gas Act, enacted three years later, provided an on-going program of protection to the consumer from the abuses of Holding Companies which occurred prior to 1938. This Natural Gas Act system continues unabated and will continue if the Public Utility Holding Company Act is repealed.

The Natural Gas Act provides the FERC with complete and total authority to protect the consumers of natural gas from paying any charges and costs which are not directly related to the transportation of natural gas transported in Interstate Commerce. [1/] The commission determines in the first instance that any rate charged is just and reasonable[2/] and it may on its own motion or upon complaint of any State, municipality, State commission, or gas distribution company investigate any aspect of natural gas service affecting the rate or charges for service, determine the just and reasonable rate, and reduce the rates and charges if found to be unjust and unreasonable.[3/]

The Natural Gas Act also prevents any natural gas cmpany from extending or abandoning any service without permission by the FERC.[4/]

In short, the Natural Gas Act provides the authority, which has been developed and exercised over 40 years by the FERC, to isolate those services affected with the public interest from any and all other operations of a natural gas company which have not been so determined by law to be affected with the public interest.

[1/] Natural Gas Act Sec. 4(a).

[2/] Ibid: Sec. 4(e).

[3/] Ibid: Sec. 5(a).

[4/] Ibid: Sec. 7(a).

In my experience, I know of no regulatory gap which exists now or could occur if the PUHCA were repealed. In addition, to my knowledge there has been no instance whereby FERC officials have found it necessary to rely or call upon SEC authority under PUHCA to assist in performing their responsibilities under the Natural Gas Act.

Mr. Luther Heckman, former Chairman of the Ohio Public Utilities Commission, has filed testimony discussing regulatory coverage of State authority to protect the public interest at the State level.

As a former member and Chairman of the Federal Power Commission, I have focused on the impact of repeal legislation on utility consumers primarily at the Federal level. I conclude that there would be no adverse impact, and that what impact there is, is most likely to be beneficial. Unlike in 1935, Federal and State regulatory commissions now have adequate authority and competence to protect utility consumers from the abuses found to exist in the 1920's. Perpetuation of the Act would continue to inhibit registered companies from opportunities to become stronger companies, without offsetting benefits.

Mr. Chairman, I have included in the balance of my testimony some of the specific regulatory and accounting systems and methodologies that are now in place and which address and now solve the problems that concerned Congress in 1935. These subjects are accounting, cross subsidization and cost-of-capital. I will not read these sections but would be happy to answer any questions.

I have also included my opinions as to some of the potential benefits of repeal of this act, but this has also been covered by other witnesses.

Conclusion

The regulatory systems now in place at both the Federal and State levels concentrate on preventing abuses and protecting consumer interest. In the 44 years since enactment of the Natural Gas Act and the subsequent and parallel development of State regulatory systems, there has been not one uncorrected abuse of the nature described in the FTC report.[4a]

This concludes my remarks and I thank the Committee for having given me the opportunity to be heard.

[4a] Federal Trade Commission, Report on Utility Corporations S. Doc. No. 92, 70th Congress (1935)

I. Accounting Systems

Section 1(b)1 of the Act set forth as one of the major problems to be addressed the "lack of uniform system of accounts."

Perhaps the single most important development under has been the widespread establishment of such uniform systems of account.

(a) Pursuant to the mandate of the The Natural gas Act of 1938, the Federal Power Commission promulgated a uniform system of accounts for natural gas companies subject to its regulation.

(b) The National Association of Regulatory Commissioners adopted a uniform system of accounts which paralleled and is totally compatible with the FPC system.

(c) All states and Canada have adopted either the FPC or NARUC systems.

(d) The FASB, though not a governmental regulatory body, establishes generally accepted accounting principles in accordance with which financial statements must be prepared if auditors are to give an unqualified opinion.

A single uniform system of accounts is thus required and in place for all natural gas companies subject to Federal supervision and all gas utilities subject to state jurisdiction. This provides the financial information base whereby State and Federal regulators can and do protect the consumers or users of utility services from cross subsidization and misallocation of costs between utility and non-utility operations. It enables states to ascertain assets and costs properly attributable to the utility services provided within the particular state, just as it enables FERC to trace and isolate accounting information attributable to the utility services used in interstate commerce. Continued achievement of the first purpose of the Act is, therefore, assured, without the 1935 Act.

II. Allocation of Reasonable Costs and Cross-subsidization

Pursuant to the Natural Gas Act, the FERC has developed a ratemaking system, and State Regulatory Commissions have developed parallel ratemaking systems, which together protect utility retail customers from improper intercompany charges.

The heart of the ratemaking process for both Federal and State regulatory bodies is the requirement that the involved companies prepare a cost-of-service case identifying all costs related to the utility services provided by the company.

The cost-of-service must include all and only those items of cost attributable to the provisions of the utility service, such as operating expenses, depreciation, taxes and return. Each element must be determined to be reasonable, and then allocated between jurisdictional and non-jurisdictional services. The rates charged consumers are thus based solely on reasonable jurisdictional costs.

Joint or common overhead costs are allocated between jurisdictional and non-jurisdictional service pursuant to a series of established allocation procedures developed and approved by the regulatory bodies and the courts. The Massachusetts formula, for instance, allocates joint or common costs that cannot otherwise be assigned directly to an activity or service on the basis of a three part formula of revenues, plant and labor costs. 5/

5/ Opinion No. 444, 32 FPC 993, (1964). Indirect A&G expenses are those expenses which cannot be directly assigned to a specific company either because a direct causal relationship cannot be established or because the expense was incurred for the benefit of the organization as a whole (MGT-T-5A, p. 3). In the case of Tenneco, (1) all costs that can be are directly assigned (such as data processing services which are allocated on a usage basis) (MGT-T-5B, p. 2), and (2) where a causal relationship can be established between a certain expense and a given factor, those costs are allocated based on that factor (such as the costs of the employee center which are allocated on a labor basis) (*Id.*) The remaining or residual, A&G expenses are the indirect Tenneco A&G expenses here involved which must be allocated on a formula basis. Significantly, there is no dispute as to the level of A&G expenses to be allocated. In this opinion the Commission adopted the conclusion and analysis of Chief Presiding Examiner Zwerdling, who found that the Massachusetts formula was the "Common sense and fair approach . . ." (32 FPC at 1024). The Massachusetts formula is not a rigid formula. In every rate case the allocation of joint, shared, or indirect costs are subject to presentation, FPC staff analysis and cross examination and judicial review. The point is that a method exists which is well established that resolves the cross-subsidization problem between regulated and non-regulated enterprises of a Holding Company.

The rate case process is supplemented by required filings of extensive and detailed accounting data and by the commissions' investigatory authority to inquire into and take remedial action on any corporate activity which may affect the utility operations and the ratepayer.[6]

These comprehensive regulatory systems have protected consumers from cross-subsidization of the diversification costs of interstate pipelines and exempt gas utility companies, as well as now-registered gas companies.

III. Cost-of-Capital

After the determination of reasonable costs and their allocation, the ratemaking process determines rate-of-return on capital invested in the regulated business. There are two controlling principles: (i) only capital costs attributable to utility property or services are paid by the ratepayer, and (ii) rate-of-return for a utility is determined by the cost of capital of companies with a similar degree of risk. This substantially insulates ratepayers from high capital costs incurred in more risky or unsuccessful non-jurisdictional activities. They are further protected by increasing empirical evidence that diversification lowers the variability of earnings while preserving the investors' expected return, with the combined effect of lowering both debt and equity costs.

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[6] See RP74-87 Investigation of Pennzoil Company - United Gas Pipeline Company and Related Transaction. The Federal Power Commission in 1974 exercised its authority under Section 14 of the Natural Gas Act by ordering an investigation of the "spin-off" of United Gas Pipe Line Corporation from Pennzoil. This case illustrates that the Natural Gas Act provides (con't)

Three attached tables show a 10-year historical comparison of return on equity, return on capitalization, and price-to-book ratio for the three registered gas utility systems and other segments of the gas industry. The reasonable, if not inevitable conclusion, is that the market evaluates all other gas transmission/distribution companies higher than these three companies, thereby reflecting lower costs-of-capital for the other companies.

6/ (con't)

sufficient authority to protect the public interest regulated activities within a holding company. The FPC investigation was initiated by the Commission on the basis of Pennzoil's filing under the Securities and Exchange Act of 1933, not the Public Utilities Holding Company Act of 1935. The final order and Settlement of November 28, 1975 approved a settlement modifying significantly the time of the "spin-off"; the principle finding was that the settlement was in the best public interest and that "it has sulutory effect upon United's financial stability and availablility of gas supply." (54 FPC 2515)

IV. Benefits

The first and immediate benefit to consumers of repealing the Act or of exempting gas companies from it will be the reduction of direct and indirect regulatory costs, governmental and private, which taxpayers and ratepayers incur.

The second and more profound benefit will be the opening of opportunities now closed to registered utility systems to build stronger companies, able to do more for their consumers, their investors and the general public. Such added strength is needed to meet the intensifying competition for financing natural gas resources, ancillary facilities such as storage, and supplementary gas supplies such as coal gasification, SNG, or LNG. Perpetuation of an additional and unnecessary regulatory hoop will, on the contrary, detract from their ability to provide basic utility services.

Eliminating the costs of unnecessary and timetaking regulation is even more essential than the unlimited right to diversify. It does not follow, however, that a utility should be allowed to invest only a limited and specified percentage of its assets in non-utility activities over a specified period of time, or that diversification be specifically limited, as to "energy-related" activities. My experience as a Federal regulator and as a State government official persuades me that the main contribution of such limitations would be to perpetuate and probably increase counterproductive regulatory burdens -- by promoting extended periods of rulemaking and litigation on questions of basic definitions. The most probable service and rate impact of excluding the three companies from the Act's regulation would have probable beneficial impacts on service and rates. The benefit is hard to quantify, but the question is only of degree, whereas an adverse impact on gas consumers can be prevented, and so is improbable.

Since, in addition, the Act now inhibits companies subject to it from timely seizure of many opportunities to develop into stronger companies, the net impact on consumers is clearly more likely to be beneficial.

I, therefore, recommend exclusion of gas utilities from the PUHCA Act of 1935.

GAS INDUSTRY ANALYSIS
RETURN ON EQUITY

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1970	11.870	8.570	7.026	.000	12.859	11.196	11.881
1971	11.813	9.904	9.498	.000	12.773	11.821	12.213
1972	12.037	10.007	11.853	.000	12.849	12.460	12.620
1973	11.930	8.657	9.809	13.871	14.220	11.948	13.069
1974	11.574	9.328	10.130	13.731	15.426	11.078	13.086
1975	10.663	9.650	9.302	14.964	16.107	11.834	13.903
1976	11.829	12.338	10.036	15.591	17.506	11.595	14.350
1977	11.435	13.191	9.556	15.900	16.650	11.711	14.127
1978	12.190	12.425	10.078	15.557	16.027	12.062	14.025
1979	13.035	13.090	11.070	17.077	17.385	13.095	15.254
1980	13.875	11.395	10.131	19.325	17.862	12.251	15.430

1 - COLUMBIA GAS SYSTEM
2 - CONSOLIDATED NATURAL GAS
3 - NATIONAL FUEL GAS CO.
4 - GAS TRANSMISSION COS.
5 - GAS TRANSMISSION-DISTRIBUTION COS.
6 - GAS DISTRIBUTION COS.
7 - ALL GAS COMPANIES

GAS INDUSTRY ANALYSIS
RETURN ON TOTAL CAPITALIZATION

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1970	5.129	4.640	3.425	.000	5.525	4.336	4.826
1971	5.051	5.294	4.592	.000	5.399	4.431	4.830
1972	5.115	5.362	5.825	.000	5.538	4.777	5.090
1973	5.093	4.644	4.821	5.339	6.418	4.781	5.460
1974	4.794	5.033	5.367	5.165	7.244	4.320	5.498
1975	4.251	4.868	4.705	6.321	7.708	4.707	6.053
1976	4.849	6.250	4.901	6.883	8.761	4.644	6.465
1977	5.294	6.776	4.347	7.508	8.773	4.930	6.689
1978	5.766	6.743	4.798	7.666	8.752	5.224	6.852
1979	6.162	7.112	5.000	8.577	9.983	5.871	7.744
1980	6.779	6.416	4.747	9.630	10.836	5.764	8.149

1 - COLUMBIA GAS SYSTEM
2 - CONSOLIDATED NATURAL GAS
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4 - GAS TRANSMISSION COS.
5 - GAS TRANSMISSION-DISTRIBUTION COS.
6 - GAS DISTRIBUTION COS.
7 - ALL GAS COMPANIES

GAS INDUSTRY ANALYSIS
PRICE TO BOOK RATIO

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1970	1.291	.867	.809	.000	1.505	1.226	1.341
1971	1.319	.906	.818	.000	1.543	1.247	1.369
1972	1.196	.890	.815	.000	1.486	1.186	1.309
1973	1.093	.785	.735	.885	1.195	.934	1.021
1974	.758	.611	.600	.938	1.081	.759	.905
1975	.840	.649	.606	.910	1.097	.744	.898
1976	.852	.765	.682	1.033	1.240	.879	1.031
1977	.893	.827	.715	1.122	1.223	.905	1.051
1978	.847	.856	.668	1.054	1.096	.871	.979
1979	.818	.847	.652	1.116	1.111	.857	.989
1980	1.123	.945	.644	2.047	1.487	.853	1.288

1 - COLUMBIA GAS SYSTEM
2 - CONSOLIDATED NATURAL GAS
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4 - GAS TRANSMISSION COS.
5 - GAS TRANSMISSION-DISTRIBUTION COS.
6 - GAS DISTRIBUTION COS.
7 - ALL GAS COMPANIES

GAS INDUSTRY ANALYSIS
OF COS.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1970				0.	14.	20.	34.
1971				0.	14.	20.	34.
1972				0.	14.	20.	34.
1973				9.	21.	28.	58.
1974				11.	21.	28.	60.
1975				11.	21.	28.	60.
1976				11.	21.	29.	61.
1977				11.	21.	30.	62.
1978				11.	21.	30.	62.
1979				11.	21.	30.	62.
1980				12.	20.	30.	62.

1 - COLUMBIA GAS SYSTEM
2 - CONSOLIDATED NATURAL GAS
3 - NATIONAL FUEL GAS CO.
4 - GAS TRANSMISSION COS.
5 - GAS TRANSMISSION-DISTRIBUTION COS.
6 - GAS DISTRIBUTION COS.
7 - ALL GAS COMPANIES

Senator D'AMATO. We will call the third panel: Mr. John L. Cabot, senior vice president of Cabot Corporation; Mr. Richard Rosenthal, chairman of the Citizens Utilities Company; and Mr. John Barr, Morgan Stanley.

STATEMENT OF JOHN G. L. CABOT, SENIOR VICE PRESIDENT, CABOT CORP., BOSTON, MASS.

Senator D'AMATO. Mr. Rosenthal is apparently coming from Connecticut, and that State has been literally washed away. So, he may be coming down by boat instead of plane. Consequently, he has been delayed.

Mr. Cabot?

Mr. CABOT. Thank you, Mr. Chairman. I appreciate the chance to appear here and to support the repeal or significant amendment of the Public Utility Holding Company Act. If I may, I will depart from my prepared statement in order to abbreviate my comments in view of the time.

[The complete statement follows:]

Testimony of

John G. L. Cabot
Senior Vice President

Cabot Corporation

I am pleased to appear before you today on behalf of Cabot Corporation in support of repeal or significant reform of the Public Utility Holding Company Act of 1935. My name is John Cabot. I am Senior Vice President of Cabot Corporation with responsibility for the overall operation, profitability and return on investment of the company's Energy Group.

BACKGROUND ON CABOT

Cabot was founded exactly 100 years ago. It is a Boston-based manufacturer with annual sales of approximately $1.6 billion. Our businesses include energy, specialty metals and performance chemicals. In the Energy Group, Cabot explores for and produces crude oil and natural gas, operates gas processing plants, natural gas pipelines and a distribution system, and imports and sells liquefied natural gas (LNG). The Engineered Products Group produces and sells specialty metals, alloys, compounds and materials for use in the aerospace, chemical processing, nuclear, paper, pollution control, aluminum and electronics industries. Energy absorbing resins and noise control products are also manufactured by the Engineered Products Group through a subsidiary, E-A-R Corporation. In the Performance Chemicals Group, Cabot is the leading worldwide producer of carbon black, a chemical used primarily as a reinforcing agent in rubber tires; and is the largest domestic producer of CAB-O-SIL fumed silica, used principally as a reinforcing agent in silicone rubber and thickening agent for liquids.

A small part of Cabot's business is a state-regulated natural gas utility which operates as a division in West Virginia. In calendar year 1980, Cabot utility revenues of $15.5 million represented less than one percent of Cabot Corporation's consolidated worldwide sales. Being approximately 99 percent diversified puts us at the extreme end of the range of companies that have both utility and non-utility interests (Chart 1).

Cabot entered the utility business quite by accident. In the late 1800s and early 1900s, the company explored for and produced natural gas in West Virginia and Pennsylvania to suppply its carbon black manufacturing operations. The company permitted rural West Virginians to purchase excess gas supplies from

Cabot's pipelines. These sales became regulated as state and federal utility regulation evolved. The Cabot utility is currently regulated by the West Virginia Public Service Commission.

At the April 27 hearing, questions were raised by witnesses concerned about prudent diversification and associated risks. As a diversified concern with over $1.6 billion in sales, we believe we can address those concerns. We believe that our record confronts directly the implicit assumption in the Public Utility Holding Company Act—that mixing utility businesses with non-utility businesses is somehow bad.

Cabot Corporation has experienced outstanding growth in recent years. Our return on equity has averaged 24.7 percent over the last three years. We are a world leader in the carbon black and specialty metals markets. In short, we have been successful at managing a diversified business. We have successfully managed a utility business as well. Over the last decade we have had the lowest retail gas rates of any major West Virginia utility and we have a better record of gas availability during the last decade of shortages.

Even though we have been a success in both utility and non-utility business, the Holding Company Act places a burden on our organization. The utilities which would like to start diversifying have advised you of the problems caused for them by the Act. Cabot is at the other end of the spectrum. The Act forces us to organize our business in an awkward way and makes it very complicated for us to expand utility operations—for example, to another state, should we wish to do so.

A utility has special regulatory requirements which argue for separating utility operations from other businesses within the overall corporate structure. The logical way for Cabot to do this would be to operate its West Virginia utility as a subsidiary. But, despite approaches to the SEC in 1968 and 1980, we have been unable to obtain an exemption from the Holding Company Act, and we have been forced to operate our utility in the parent company. If we were to place our utility business in a subsidiary, the Corporation would then become subject to the requirements of the Act, and we would have to divest all businesses not "reasonably incidental" to our utility business. In short, we would have to sell most of Cabot Corporation.

As a result, Cabot has been forced to operate its utility as a division, with the entire parent company as the utility of record in West Virginia, rather than as a wholly-owned subsidiary. This means, from a practical standpoint, economic inefficiencies are created that burden the corporation, its utility and its customers. For example, the reporting burden on the parent corporation is great. We believe that no counsel of any other major corporation would recommend it enter the utility business unless the utility could operate as a subsidiary. In addition, in past proceedings before the state regulatory commission, neither the commission nor Cabot has been able to satisfactorily define what the utility is in terms of assets, debt and equity and liability for taxes. This has made ratemaking an uncertain procedure at best. If the Holding Company Act was repealed or changed, Cabot could operate the utility as a subsidiary. The utility would be a well defined separate corporate entity with known assets, debt and equity and taxes, with the flexibility to assume a typical utility industry debt structure. Generally, utility industries are characterized by more favorable debt to equity ratios, which have historically reduced the cost of capital to utilities. We do not understand why Cabot or any other company should be prevented from organizing its businesses in a straightforward, logical manner.

Clearly, the most important contribution we can make today is to reassure this subcommittee that relaxation of the Act is in the best interests of the consumer and the stockholder. We believe that a diversified company can be just as committed to its utility customers as a non-diversified enterprise; that the ratepayers and stockholders can benefit from the relationship and that there is no reason, then, to continue to isolate utilities from other enterprises. They can be run together, efficiently and profitably. Rather than talk in theoretical terms about what would be done with the relaxation or repeal of the Holding Company Act, we believe it would be more valuable for this Committee to look at empirical evidence—the record of the Cabot utility.

I am proud of our record in West Virginia. The chart before you (Chart 2) shows the recent average price per household for natural gas for the major retail utilities in West Virginia based on pending rate cases in November 1981. As you can see, the average price ranges from $5.22 per mcf to $3.42 per mcf with Cabot at the low end of the scale. Several of these companies are registered holding companies under the Act and are subject to restrictions which probably affect their results. In any case, from our point of view Cabot's lower gas rates support the notion that a diversified company with a utility can deliver services efficiently and to the benefit of those utility customers.

Cabot can sell gas more cheaply because our West Virginia operations are a compact, efficient blend between the residential and industrial user, and the system is properly incorporated into the Cabot Energy Group. We are a large driller in West Virginia and have been in the business for a long time. We began an aggressive gas development program in 1970. Our program was a success, and as it turns out, invaluable to the utility because enough new production was generated to more than cover our utility's needs. Each business—production and distribution—was run independently, run at its own pace and not as the handmaiden for the other. Thus, our natural gas production was expanded as fast as opportunity would allow, not just to supply our utility. The utility ultimately benefitted because we were never short of gas. In fact, we are unusual in the state because we have had no sales restrictions in the last decade, as the final chart before you indicates (Chart 3). In short, we run our utility like a business, where we look for opportunities to blend the utility needs into our other businesses, not vice versa.

An important public policy issue before the Congress is whether it is in the public interest to maintain the wall erected by the Act between public utilities and other businesses. We believe that this wall has created artificial economic distortions and that its removal would permit some benefits to accrue to utility customers. Again, there is no reason to believe that a utility cannot benefit from its association with a generally non-utility oriented business. The question is not whether diversification is a good idea, because in some cases it is not, but whether it should be prohibited by statute in all cases—even when it is a positive step. There are numerous checks, such as through state regulatory authorities, to prevent poorly thought out diversification plans. But, there is no reason to penalize everyone, through a wide-ranging federal statute like the Holding Company Act, from pursuing prudent diversification practices.

In my experience, the general requirements for utility and non-utility management are similar; both need to maintain a desirable return on stockholders' equity and to set operating and financial objectives. Although techniques and technology used in operations may differ, the standards of efficiency, quality and properly adapting to new conditions and opportunites are equally important to both businesses. The question before this subcommittee is whether the Holding Company Act should continue to isolate utilities from the experience of free-market enterprises and vice versa.

Beyond these points, which I would be happy to discuss in greater detail today or at a later date, I would like to echo some of the statements made here this morning that indicate that virtually every important regulatory section of the Act is covered by other federal and state regulations. These points are covered in detail in an attachment to my oral testimony which we will submit for the record.

Mr. Chairman and Members of the Subcommittee, I appreciate the opportunity to present our views to you on this important issue. We hope that the Senate will move to repeal or significantly reform the Holding Company Act this year so that Cabot can organize our utility as a subsidiary and other, even more restricted companies may begin to enjoy the financial flexibility and rewards of the free market. I would be happy to answer any questions you might have.

Chart 1

CABOT CORPORATION
Net Sales vs Utility Sales

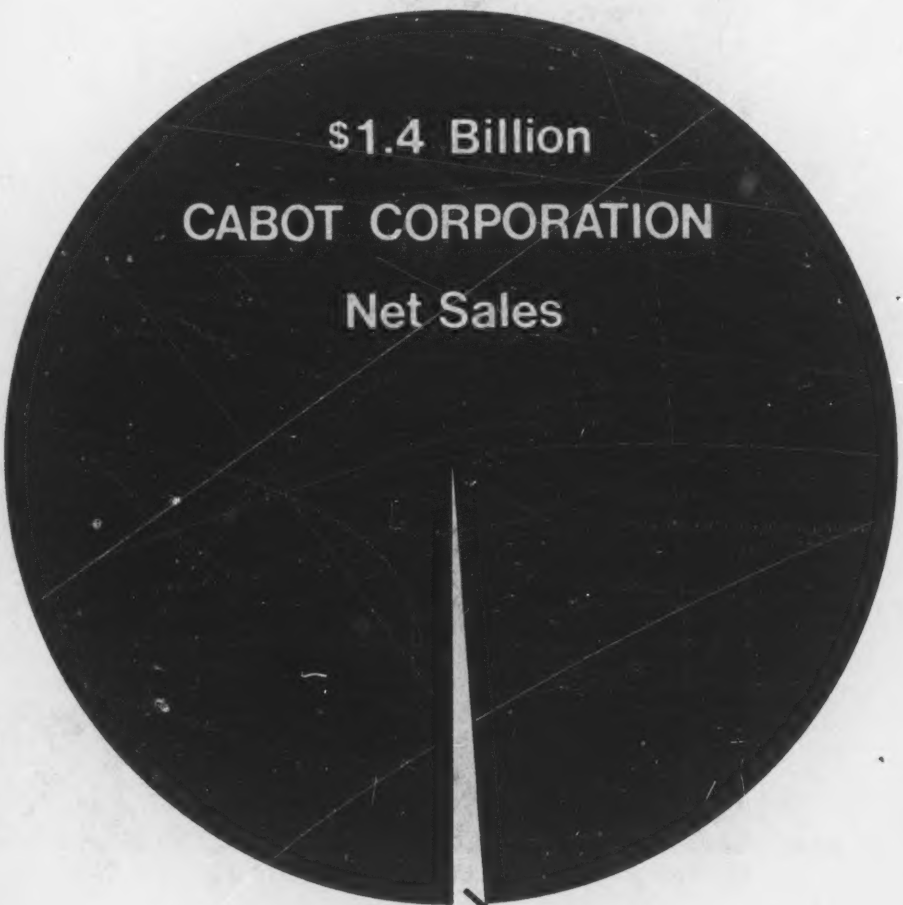
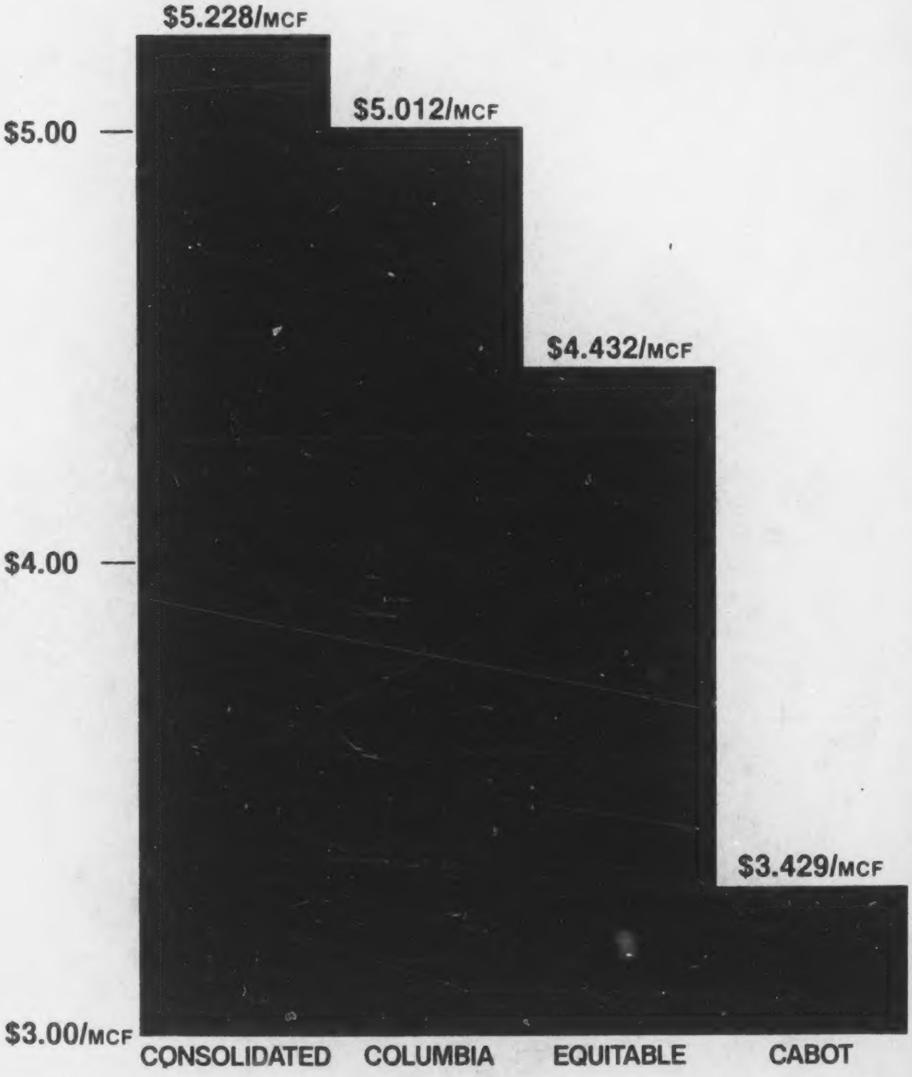


Chart 2

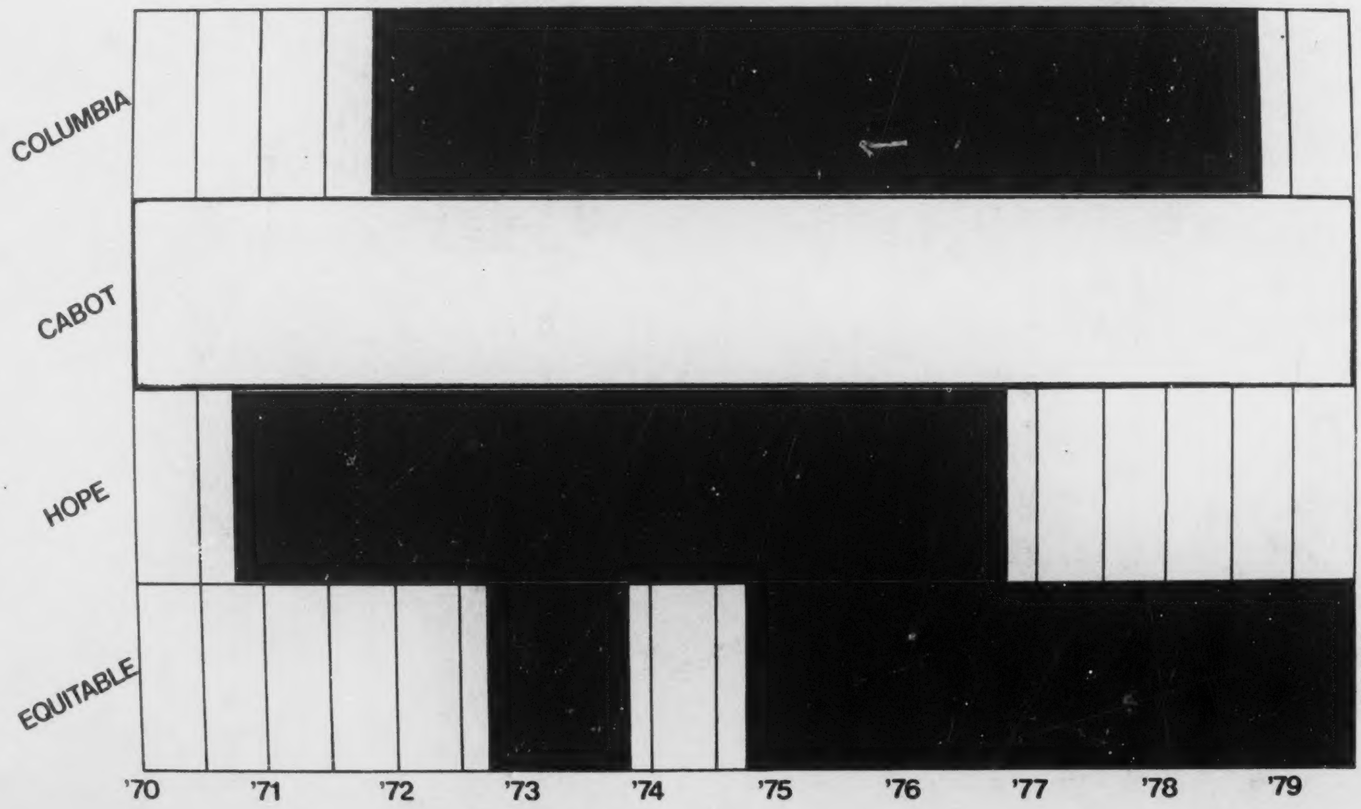
*AVERAGE PRICE FOR HOUSEHOLDS USING 12 MCF PER MONTH



*Based on pending rate cases effective November 1, 1981

Chart 3

SALES RESTRICTION PERIODS



ATTACHMENT 1

FINANCIAL PRACTICES AND INFORMATION DISCLOSURE

Some concern has been raised that reports filed under the Holding Company Act are in many cases the sole source of information required by state utility regulators to carry out their rate-making function. This is not correct. All public utility holding companies presently registered under the Holding Company Act also have securities registered under the Securities Exchange Act of 1934, which requires regular information disclosure by all companies which are listed on a national securities exchange or which have one million dollars in assets and 500 stockholders. In addition, all companies are subject to the Securities Act of 1933 when making a public distribution of securities. The disclosure systems of the Securities Act and the Exchange Act were just being developed when the Holding Company Act was adopted. Since that time, however, the scope and sophistication of these systems have grown enormously, going beyond the requirements envisioned for the Holding Company Act. For example, publicly held companies are required to disclose the revenues and profits from various segments of their business as well as the assets utilized in each segment. Comprehensive, audited financial statements must be furnished both in connection with securities offerings and on a regular basis, as well as information concerning the nature of a company's business, properties, management and capitalization.

The reporting requirements under the Holding Company Act and the Securities and Exchange Acts are largely repetitive. For example, we can find only two major differences in information required, comparing the annual report on Form U5S under the Holding Company Act and the periodic reports on Forms 10-K, 10-Q and 8-K under the Exchange Act. First, Form U5S requires a tabulation of political and public relations expenditures. Second, it requires a description of all service, sales and construction contracts between system companies (except contracts approved by the SEC under the Holding Company Act). Reports filed under both statutes include information regarding the acquisition or sale of assets, the issuance and retirement of securities, investments in utility and non-utility businesses, principal owership of holding company securities, management, material litigation and audited financial statements.

The major difference between the reporting requirements under the two acts is that the Holding Company Act requires more detailed information. In light of this fact, the information requirements of state utility regulators could be met under the Exchange Act even if the Holding Company Act were repealed. Furthermore, if the Congress concluded that more detailed information were required about utility holding companies than about other companies, the SEC could use its authority under Section 19 of the Securities Act and Section 23 of the Exchange Act to establish special disclosure requirements by rule. For example, the SEC has adopted a special industry guide which requires oil and gas producing companies to provide special information about their businesses. A similar approach could be used to assure that the repeal or modification of the Holding Company Act would not result in a reduction of essential and useful information to investors and state utility regulators.

In addition, the world has changed a great deal since the Holding Company Act was passed in 1935. The standards of the investment community have become more sophisticated. Securities rating agencies (Moody's and Standard and Poor's) and investment banking analysts keep a careful watch over all major corporations. Clearly, rating services and investment firms sizeable enough to handle new stock offerings would shun holding companies with a financial structure like those which characterized utility holding companies prior to 1935.

Finally, there is far more effective and sophisticated state regulation today than in 1935. The state public utility commissions can eliminate the vast majority of improper financial practices which were common before 1935. Their review is intense and frequent. For example, Cabot's rates are regulated by the West Virginia PSC, and every disposition of any asset of the utility requires advance Commission approval.

ACCOUNTING PRACTICES

Under the Holding Company Act, the SEC has the power to impose a uniform system of accounts on registered companies. However, the SEC has so effectively exercised its broad powers under the Securities Act and the Securities Exchange Act to establish standards for Uniform System of Accounts that, in 1975, it decided a separate system under the Holding Company Act was unnecessary.

Today, through Regulation S-X and nearly three hundred Accounting Series Releases, the SEC maintains accounting standards for all public companies.

Moreover, since the Holding Company Act was passed both the states and the federal government have adopted a uniform system of accounts for public utility companies pursuant to authority granted by other statutes. For example, the Federal Energy Regulatory Commission (FERC) has adopted a uniform system of accounts which all jurisdictional natural gas companies must follow, and the West Virginia PSC has adopted a uniform system of accounts based on the FERC model.

In 1935, the means of establishing and enforcing generalized accounting principles barely existed. Since then, the accounting profession has established an elaborate mechanism for the development of generally accepted accounting principles and an effective means of compelling adherence to them under the Financial Accounting Standards Board (FASB). All public companies are required by the Exchange Act and the rules thereunder to file with the SEC and to send to their shareholders financial statements reviewed by independent public accountants. In addition, section 13(b)(2) of the Exchange Act mandates a system of accurate recordkeeping and adequate internal controls.

Mr. CABOT. I would like to stress the very unusual nature of our company. I am not aware of any others like us. We are a large diversified manufacturing company. We have sales internationally and nationally in the range of about $1.6 billion.

We operate in most of the industrialized countries of the world. We have plants there and in developing countries. We participate in a great many businesses.

[Chart.]

Practically all of our business is free market business. We compete with other companies all over the world in many different ways. There are lots of companies like this, of course, in our economy. However, the thing that distinguishes us is that we have a very small utility business. In other words, we span the two types of activity, and there aren't very many companies that do that.

The chart before you represents what 1 percent of one's sales looks like in a large company, being 1 percent utility and 99 percent nonutility business.

As with all the other witnesses in the preceding panel, the right way for us to organize would be as a holding company. Our utility should be in a subsidiary. It should not be in the parent company the way it is today for many reasons which I will elaborate, but we are unable to do that because of the existence of the Public Utility Holding Company Act. And we have tried twice to obtain an exemption from the act so that we could do precisely that, and twice we have failed.

HISTORIC ACCIDENT

Now, you may ask me why we decided to get into this little utility business, and the answer is very simple. It was an historic accident. We didn't know that the Public Utility Holding Company Act would pass. We didn't even know that there would be a West Virginia statute establishing utilities as a distinct form of enterprise in that State, because we were in this business at the turn of the century, about 15 years before the State Public Service Commission statute was passed.

We got into the utility business by the simple fact that in West Virginia at the turn of the century we operated natural gas pipelines to supply our chemical plants, and we were willing to hook up rural customers on our pipelines and offer them gas service. We didn't know what we were getting involved in.

But, I think, in a sense we are a prototype of a problem that other diversified companies must face if they had surplus electricity or surplus gas and faced the problem—are we going to treat our neighbors the way we like by offering them service, or stay clear of this really very significant legal tangle that a corporation gets mixed up in, if they do what we did.

Now, I will skip over large sections of what I had in my prepared testimony in order to make a few very specific points. I would like to brag a little bit first. I would like to say that we are quite successful in both enterprises, both the diversified part of our business and in the utility part of our business.

I think that is significant, because, in my opinion, each one can bring something to the other, particularly the diversification to the utility. In our diversified business, as I say, we compete worldwide. We are successful. We are the leader in several businesses. We compete with the Japanese; we compete with the Europeans; we compete with the best we can find.

In the utility business I think we do very well also, and I would like to put on this chart here something which compares our retail natural gas rates in West Virginia to the rates of the other principal utilities in that State.

[Chart.]

In order to be very impressive, we truncated the chart. It really starts at $3. It doesn't start at zero. Nevertheless, the point I would like to make is that our operations, for whatever reason, succeed in delivering gas to consumers in West Virginia a great deal more cheaply than traditional utilities. in fact, we have the lowest gas rates in West Virginia.

Now, I would like to say that is all because of our genius, but, in fact, I would like to call your attention to a few things that I deeply believe. First, I believe that that result would have been absolutely impossible had we not been diversified. And I will be glad to elaborate on that point if you wish.

Senator D'AMATO. Yes, I want you to elaborate on that, please.

Mr. CABOT. All right. Had we been just a utility in West Virginia and nothing else at all, that would not have been the result. Now, this argument has two dimensions. The narrow dimension is what we did specifically that led to this result, the physical things that we did, that is, what facilities we built, what contracts we entered into, et cetera.

Specifically, just over 10 years ago, we decided to rebuild our gas business from the ground up. We believed at that time that it would be impossible to do what had to be done in view of the impending energy crisis within a utility framework. So we completely rebuilt our business outside of the utility. We established a total new gas business including production, a pipeline system, et cetera and built a much bigger gas business all around our utility.

And you might think, well, so what, what does that do to the utility? The fact of the matter was that the specific problem during this decade was a shortage of gas, and because we were very active in pursuing the gas business for the business opportunity, the diversified business opportunity, rather than just doing what was absolutely necessary in our utility business we always had plenty of gas. We were able to keep the pipeline system fully loaded and thus reduce unit cost, and the result is there.

That is a specific reason for our success. That is what we did, because we approach our business with a diversified attitude. Each business stands on its own feet. Each one is run by a different manager. He does what is good for that business. And as a result the success of one business manager can help the business, and customers, of another manager.

Now, the more general point I would like to make is that had we thought of this as just a utility business, had we had a management that was narrowly focused on the problem of just serving those customers, we might have overlooked the opportunity to build an aggressive gas business altogether. Because that is not the way we are organized, we did see that opportunity, as many others around the world have seen. We happened to do this in this place at this time, and it happened to be very good for our ratepayers as well as for us. We have done very well in the gas business in West Virginia.

And I think you will also see it in another chart I have here. During this period of shortages it was very hard for many companies to maintain their gas supplies to customers. We never had that problem.

[Chart.]

That blue line indicates we always had plenty of gas for all our customers; including industrial customers; whereas, most of the larger gas companies simply couldn't do that. They couldn't maintain their supplies for reasons, of which you are well aware, that go back to wellhead price regulation of many years ago.

The reason I make both of these points, before telling you precisely what our problem is with our corporate organization, is that I think there's an implication through much of the discussion we've heard today and elsewhere that somehow controls are on the side of the consumer and repeal or reform of the act is on the side of management. That is precisely the point that I think is contradicted by these charts. I believe our experience indicates that in certain instances relaxation of regulation works for everybody as it should. It works for the consumer; it works for the management; it works for the stockholder. In West Virginia, it worked for the economy because of the degree of Cabot's business development, and it worked for us. We had a lot of fun working in an innovation environment. It was a nice place to do business.

OPERATE UTILITIES AS SUBSIDIARIES

Now let me get back to our specific problem that is created by the Public Utility Holding Company Act. As I say, we would like to be a holding company. We would like to operate our utilities as subsidiaries for all of the good reasons which were presented by other people, which I won't repeat. We are unable to do that. We simply cannot put up with the sanctions of the Public Utility Holding Company Act, the most drastic of which could force us to divest 99 percent of our business and end up being a very tiny utility in West Virginia. Clearly, that would be an absurd result for us. Therefore, we operate our utilities in the parent company.

Now we do that of necessity, because of the fact that we entered the business years ago, and we're doing the best we can under the circumstances. I don't think any diversified company would do that today if it had the option of deciding whether to enter the business, because a parent company, after all, is the nerve center of a corporate structure. It's the hub of everything. And if you try to operate both a utility business and a worldwide diversified company within the same corporation, you run into interference of all kinds. Maybe none of it is very serious, but it's a complexity. I think any general counsel would tell you, don't do it, please don't do it. Stay away from it.

It's a potential for no end of complexity, and it prevents us from being able to put all our utility business in a package which would be easier for the regulators, easier for us, and easier to establish intercorporate relationships, whatever they may be. So that's our specific problem. We would like enough relaxation of the act so we can operate our utility as a subsidiary. If we could do that, I think we would maintain all the advantages we have had from being affiliated with a diversified enterprise, and we would remove those things which have been penalizing us in the way we operate.

I think that's all I would like to say at this time. Thank you very much.

Senator D'AMATO. Thank you very much, Mr. Cabot.

Mr. Barr?

STATEMENT OF JOHN W. BARR, PRINCIPAL, MORGAN STANLEY, INC., NEW YORK

Mr. BARR. Mr. Chairman, good morning. My name is John Barr. I'm a principal of Morgan Stanley & Co. I am involved with my firm's financing and advisory activities with the public utility industry.

Morgan Stanley is a leading investment banking firm in the underwriting and placement of securities for corporations.

We provide investment banking services to a broad group of client companies in the electric, gas and telephone sectors of the utilities industry, including selected registered public utility holding companies.

We are in contact with all major institutional debt and equity investors, and as a result of our activities in the merger and acquisition business, we have extensive practical experience on the subject of diversification.

Our purpose today is to support full repeal of the act. We believe the statute unduly limits the financial flexibility of the registered holding companies and also as a separate matter is a deterrent to diversification by both these companies and the utilities which are not subject to the act.

As you know, the 1935 act was established out of a concern to protect investors from abuses by utility managements. Ironically, investors today do not worry about what utility managements are going to do to them. They worry about what regulators are doing to them. The phrase regulatory risk is frequently heard in the investment community, and it reflects investor concern that regulatory decisions will impair the financial health of utilities and thereby the value of the securities which they hold. Because it limits diversification and financing flexibility, the 1935 act contributes to this regulatory risk. All of the legislative proposals which you have under consideration are constructive, because they would reduce this regulatory risk.

MAJOR REASONS FOR REPEAL OF ACT

I would like briefly to discuss two major reasons for full repeal of the act from the point of view of investors. First, the 1935 act by its very existence inhibits diversification. We believe there are numerous reasons to permit that diversification by utilities. It is a strategic alternative which is available to any nonregulated company. So we ask why should it be denied to an entire industry? It has become a very common element in U.S. business. Today about 50 percent of the Nation's goods and services are provided by companies which are diversified.

Proponents of the status quo in these hearings say diversification is possible under existing regulation. On the contrary, most utilities are inhibited from planning for diversification and from using the holding company structure which is the most appropriate vehicle, because of the restrictions of the act.

Not until the limits of regulation are clarified will the utilities pursue diversification to its full potential, and I would underscore that, recognizing that there are numerous lesser amounts of diversification underway in the industry. In addition, diversification is the only way in which utilities can establish another base of earnings to reduce the risk which comes from operating in a single line of business. There is no question that utility business has become riskier over the past decade. Financial risks, construction and completion risks and regulatory and judicial risks have made the utility business uncertain, indeed.

Investors would agree. They have suffered hundreds of millions of dollars of losses in the market value of their utility securities, both debt and equity. They no longer consider utilities a safe haven investment. Certainly, staying in only one line of business has hurt the capital formation process for utilities. Diversification is a logical way for the utilities to protect their investors against single line business risks.

Diversification can reduce business risk in another way. Vertical or upstream diversification can help the utility to insure availability of the fuels and other raw materials which it will require in the years ahead. We believe that investors favor diversification. Studies indicate that they will, on balance, pay higher prices for the securities of diversified utilities than for those of nondiversified utilities. Over time, diversification can produce a lower cost of capital by enhancing a company's appeal in the investment community and increasing the price/earnings ratio on its stock. This should result in lower rates for consumers.

Diversification favorably affects capital formation in other ways. Companies which earn a higher rate of return than available in the utility business will increase earnings per share and improve market to book ratios. In addition, a diversified utility may attract new investors who would not otherwise be buyers of their securities.

Diversification is not going to cure all the problems of the industry, but it has worked in other industries to enhance capital formation. The benefits which diversification can bring to utilities should be encouraged by removal of the unnecessary regulatory restrictions of the 1935 act.

A second major reason for repeal of the act relates to financing flexibility or lack thereof. It's a simple fact that registered holding companies have less financing flexibility than other utilities. You heard Mr. Tankersley earlier give some examples, and perhaps I could add to the list.

The requirement for competitive bidding of securities and prohibition against financing on a negotiated basis is unfair in today's volatile markets. In addition, registered holding companies are unable on short notice to change the type of securities which they will issue, the specific terms of those issues, and even the market in which those securities will be sold, in order to take advantage of rapidly changing market conditions. These kinds of changes are routinely made by other utilities. A utility financing today must choose between many trade-offs, maturity versus size, call protection versus interest rate, the public versus the private market, the United States versus the Eurobond markets.

Financings once were done over a period of months in stable markets. Now they take place in days or even hours. The principal reason is increased volatility in both the equity and debt markets. The bond market for the first time ever has become more volatile than the stock market. It commonly changes direction several times a day and may move several points in price. A company can lower the cost of capital if it has the flexibility to price a bond issue at the right moment, whenever that may be. Clearly, a registered holding company which, under the competitive bidding requirement, must accept bids at a single time, for example, 11:00 o'clock on Monday morning, does not have this timing flexibility.

To its credit, the SEC's 1935 Act division has made efforts to streamline its financing process. The problem is that market volatility, combined with the ability of other competing companies to get quickly into the capital markets, have both increased faster than this regulatory flexibility. As a result, the cost of inadequate financing flexibility is going up. The utility industry must compete for funds with industrial companies, the Government and other issuers in the capital markets. It raises more capital than any other U.S. industry, and is doing so from a position of continuing financial decline.

As a result of the financing restrictions of the 1935 Act, the registered companies are sent into these markets with one hand tied behind their back.

In summary, we support full repeal of the act, because it will enhance capital formation in one of the most important U.S. industries. It will remove financial restrictions on registered holding company and lead to lower costs of capital.

Finally, the ability to diversify is an option which should be available to all utilities given the financial weakness of the industry.

Mr. Chairman, that concludes my remarks.

Could I offer to add as a supplement to those remarks, answers to two questions which you raised in the earlier hearings and which were raised, I think, in previous days of these hearings?

One was the concerns of the plumbing, air-conditioning, heating industries, the small businesses in the service areas of these utilities, and their concerns about competition. As I understand it, their concerns paint a picture of large monopolies using their financial strength to unfairly compete against them. We have a different point of view which I can briefly express.

FINANCIAL STRENGTH IS A MISNOMER

First of all, financial strength is a misnomer for the utility industry. It's an industry that has gone from a AA status over the past decade to a single A or BBB.

Second, and clearly, although they are monopolies in the business of utilities, they are not monopolies in any of the other business areas that they would be entering.

Third, if the concern of the small companies is that there would be cross subsidization to enable these utilities to unfairly compete it is, to us, inconceivable that State Commissions would allow rate increases to consumers as a means to subsidize their entry into other businesses in which they would compete.

Finally, we'd say small companies have less to fear from utilities entering their business areas than from the large nonregulated companies. And I say that because any utility that is subject to jurisdiction will offer a court of appeal to those small companies if they do feel there is cross subsidization. A Sears Roebuck has no such State regulation and no such court of appeal.

So stepping back from this question, we would say that any capital investment in the service area is going to create jobs. If the utility supplies that capital, that's a plus for the service area.

The second point is that if diversification is successful by the utility, it will lower the cost of capital and result in lower rates to consumers. Again, another large plus for the service areas.

The last point I wanted to offer to address is your question earlier, will diversification distract utility management from the work at hand, their central business? Our view is that the obligation to serve in the basic utility business is so strongly entrenched in the utility industry that that would be very unlikely to happen. The specific case we would note is that that obligation to serve has led the utility industry over the past decade to endure the financial decline that they have undergone. This industry had a choice a decade ago. They could have selected to remain AAs and not build to serve the future load capacity. They didn't make that choice; they endured the financial decline, because that obligation to serve was so strongly entrenched.

[Complete statement follows:]

STATEMENT

OF

JOHN W. BARR
PRINCIPAL
MORGAN STANLEY & CO. INCORPORATED

My name is John W. Barr. I am a Principal of Morgan Stanley & Co. Incorporated and am involved with my firm's financing and advisory activities with the public utility industry.

- Morgan Stanley is a leading investment banking firm in the underwriting and placement of securities for corporations.
- We provide investment banking services to a broad group of client companies in the electric, gas and telephone sectors of the utilities industry, including selected registered public utility holding companies.
- As an investment banking firm, we are in continuous contact with all major institutional debt and equity investors numbering over 1,500 in this country and abroad.
- In addition, as a leading investment bank in the merger and acquisition business, we have extensive practical experience on the subject of diversification.
- Our purpose today is to support full repeal of the Public Utility Holding Company Act. We believe that this statute unduly limits the financial flexibility of the registered holding companies over which it has jurisdiction and also is a deterrent to diversification by both these utility companies and those which are not presently subject to the Act.

As you know, the Holding Company Act was established out of a concern to protect investors from abuses by utility managements. Ironically, investors today do not worry about what utility managements are going to do to them; they worry about what regulators are doing to them. "Regulatory risk" is a phrase frequently heard in the investment community and expresses the concern that regulatory decisions will impair the financial health of utility companies, and thereby the value of the securities which they hold. Because of its control over diversification and financing, the Holding Company Act can be viewed as contributing to this regulatory risk. All of the legislative proposals which you have under consideration in these hearings are constructive in reducing that regulatory risk in the minds of investors.

I would like to discuss today two principal arguments in favor of repeal of the Holding Company Act from the point of view of investors:

Diversification

First, the Holding Company Act, by its very existence, inhibits diversification by the utility industry. We believe there are numerous valid reasons to permit diversification by utilities:

1. Diversification has become a very common element in U.S. business. About 50% of the nation's goods and services are provided by companies which are diversified. Diversification is a strategic alternative which is available to any non-regulated company. Why should it be denied to an entire industry? Proponents of the status quo will assert

that diversification is possible under existing regulation. On the contrary, most utility companies are inhibited from planning for diversification and from using the holding company structure as the most appropriate vehicle for that diversification, because of the restrictions of the Holding Company Act. Not until there is clarification as to the limits of regulation will utilities pursue diversification to its full potential.

2. Diversification is the only way in which utilities can establish another base of earnings to reduce the risk which comes from operating in a single line of business. There is no question that the utility business has become riskier over the past decade. Financial risks, construction and completion risks, and regulatory and judicial risks have combined to make the utility business uncertain indeed. Investors would agree. Having suffered hundred of millions of dollars of losses in the market value of their utility securities, both debt and equity, investors no longer view utilities as a "safe haven" investment.

   Clearly, staying in only one line of business has hurt the capital formation process for utilities. Diversification appears to be the logical course for utilities to protect their investors against single-line business risks.

3. Diversification can reduce business risk in another way. Vertical integration can help a utility to ensure availability of the fuels and other raw materials which it will require in the years ahead.

4. We believe that investors favor diversification. Studies indicate that investors will, on balance, pay higher prices for the securities of diversified utilities than for non-diversified utilities. By enhancing a company's image in the investment community and increasing the price/earnings ratio on its stock, diversification over time can produce a lower cost of capital. This should result in lower costs to ratepayers.

5. Diversification favorably affects capital formation in other ways. Companies which earn a higher rate of return than available in the utility business will increase earnings per share and improve market-to-book ratios. In addition a diversified utility may broaden its appeal and attract new investors who would not otherwise be buyers of securities.

We do not say that diversification is a panacea for all problems. But it has worked in other industries to enhance capital formation. Whatever benefits diversification can bring to the utility industry should not be deterred by unnecessary regulatory restrictions.

MORGAN STANLEY

Financial Flexibility

A second major argument for repeal of the Holding Company Act relates to matters of financing flexibility -- or lack thereof. It is a simple fact that the fourteen registered holding companies have less financing flexibility than exempt utility companies. This does not mean just the requirement for competitive bidding for securities of these companies and the difficulties which they have in doing financings on a negotiated basis. It also means the flexibility for a company to change the type of securities which it will issue, the specific terms of the securities, and even the market in which those securities will be sold, thereby taking advantage on short notice of rapidly changing market conditions. At the current time, the Holding Company Act prohibits registered holding companies from making these kinds of changes with the same freedom as other utilities.

Financings today involve a variety of trade-offs: Maturity vs. size, length of call protection vs. interest rate, public debt market vs. the private placement market, the Eurobond market vs. the U.S. public market. Financings which formerly were planned and executed over months in stable markets now take place in days or even hours. The principal reason for this is increased volatility in both the equity and debt markets. The bond market, for the first time ever, has become more volatile than the stock market. Commonly changing direction several times a day, it may in the aggregate move several points in price. A company and its underwriters can lower the cost of capital if they have the flexibility to price a bond issue at the right moment, whenever that may be. Clearly a utility subject to the Holding Company Act, which under the competitive bidding requirement announces that it will receive bids at 11:00 a.m. on Monday morning, does not have this timing flexibility.

To its credit, the Holding Company Act Division of the SEC has made efforts to streamline its financing approvals process for registered holding companies. The problem is that market volatility and the ability of other capital raisers to enter the markets quickly are both increasing faster than regulatory flexibility. Thus, the cost of inadequate financing flexibility is going up. The utility industry has its work cut out for it in competing for funds with industrials, the U.S. Government and other issuers in the capital markets. Year in and year out it raises more capital than any other U.S. industry, and does so from a position of continuing financial decline. Registered holding companies do not need to have one hand tied behind their backs by being subject to the financing restrictions of the Holding Company Act.

In summary, we support full repeal of the Public Utility Holding Company Act of 1935. Only legislative action can remedy the two major problems we have discussed: unnecessary financing limitations and the inability of the utility industry to diversify freely. Repeal of the Act is one way the Federal Government can eliminate unnecessary regulation while at the same time aiding capital formation for one of the most important U.S. industries.

Senator D'AMATO. Thank you very much, Mr. Barr.

Mr. Rosenthal, I understand you came in by hydroplane?

Mr. ROSENTHAL. That, and without my water gear on.

Senator D'AMATO. You have just come in. I know you came in on very, very short notice. I am wondering if you wouldn't share with us your thoughts.

I also see that the Senate is beginning a roll call vote.

Would you proceed, Mr. Rosenthal?

STATEMENT OF RICHARD ROSENTHAL, CHAIRMAN, CITIZENS UTILITIES CO., STAMFORD, CONN.

Mr. ROSENTHAL. Surely.

First, I want to thank you and your staff for your most gracious invitation to appear here today. I am happy to do so.

I note initially that I don't appear as a protagonist. That is, I have had nothing to do with the legislation before you. I was unacquainted with its details until it was sent to me recently.

The fact that I'm not a protagonist does not mean I am not an advocate. I am an advocate—principally an advocate of rationality in government. And I think the legislation before you fits into that category.

The company I represent is not a holding company. It does not own 10 percent or more of the voting securities of an electric or gas utility. Our electric and gas operations—and there are many—are divisions of our parent company. We do own shares, more than 10 percent of the shares, of water and telephone subsidiaries.

In that connection, I would note for you that the legislation as it now stands, the Holding Company Act, does not confer any jurisdiction on the commission with respect to telephone companies, water companies, or, for that matter, insurance holding companies, railroad holding companies, or airline holding companies. All of those forms have relative freedom of acquisition, and have relative freedom of financing patterns.

It is my viewpoint that the prospective removal of controls from the utility industry, from the electric and gas industry, really, because the other aspects of the business do not have controls—that that removal is probably constructive.

The act as it stands has been inhibitive, both of financing in some respects, and in acquisitions in others; and it has also been inhibitive in the sense that it has discouraged entrepreneurial activities.

My reference point for that last is the fact that if an individual or group owns 5 percent or more of the shares, the voting shares, of two utilities, it becomes—that individual or group becomes subject to regulation as a public utility holding company. And that, in and of itself, tends to restrict owner management in the industry.

And I think if the industry could have used one thing over these past decades, it was a much greater measure of owner management than it has had.

STATES EXPANDING POWERS

In brief, it is my view that the utility industry is already a thicket of regulation. As I have experienced it, the States are always expanding their reach; that is, their alleged powers and jurisdictions. I would draw your attention to the recent acts of the California commission, in deciding that contracts really aren't contracts, if it decides that they are not. And they have so decided without much in deliberation with respect to contracts between both Pacific Gas and Electric and Southern California Edison and Standard Oil of California.

So that, as I have viewed the Public Utility Holding Company Act over some 40 years of acquaintanceship with it, and some 30-odd years of active management in the utility business, I tend to share the notion that was expressed in material that was introduced either before you or before the House, that largely what the act intended to have accomplished by the commission was in fact accomplished by the middle and late 1950's. And that what has happened since has largely been superfluous.

So that I would commend to you two things:

I would first commend the opportunity for the marketplace to take more of a role in the financing endeavors of the utility industry.

And second—and this may not be the place to make the observation, but it's my point of contact—I would commend study by a staff of the Congress, and recommendations at the end of that study, to codify this whole question of State versus Federal powers in the utility industry, State versus Federal court jurisdiction on appeal; and perhaps even some contemplation of setting up a system of regulatory courts, so that expert judges, people with real acquaintanceship with the fundamentals of the utility industry, would be looking at decisions which affect investors as well as consumers, something not disakin to the Tax Court, so that there would be an opportunity for utility shareholders to get that measure of equity which the Constitution commends and which, perhaps on all too frequent occasions, the State regulatory agencies, and even some of the Federal regulatory agencies, have tended to disregard, in their zeal to keep the shouts of the consumer representatives down to a tolerable level.

I am very happy to answer questions that reflect my own experience and our own acquisition endeavors.

The statement that I have just made to you is, of course, extemporized. But that does not in any sense diminish the intensity of my viewpoints about it.

Thank you very much.

Senator D'AMATO. Thank you very much, Mr. Rosenthal.

Yesterday, State Senator Lewis of New Mexico submitted for the record a copy of a report on electric utility diversification, by Salomon Brothers, another small company in New York. That report concluded that diversification has received a disproportionate amount of attention in evaluating the performance of six relatively diversified utilities. It found that a new diversification effort has limited chances for success, and is unlikely to have much impact on overall performance.

In as short a period of time as possible, if you would care to comment, Mr. Cabot, because the vote buzzer does call.

You know the old story of the youngster who was walking out in the hallway. He heard those buzzers going off and he said to his father, "What is that, Dad?" And his dad said, "Well, I guess another one of them has escaped." [Laughter.]

So, in a few minutes I will be racing down that hall. And if a kid says, "What is that, Pop," he will say, "It's one of those escapees."

Would you care to comment on that?

Or, Mr. Barr?

Mr. **Barr**. I will, unless you would like to?

COMMENTS ON SALOMON BROTHERS' REPORT

Mr. **Cabot**. I would just say, I can't say I have a prescription for everybody and every circumstance.

In our circumstance, our diversification allowed us to have the lowest rates and the best performance during this difficult period in West Virginia. Other people may have different experiences.

Senator **D'Amato**. Mr. Barr?

Mr. **Barr**. I might comment. If we're talking about the same report that I'm familiar with, I've seen a Salomon report that talked about the financial performance, the overall returns of six diversified companies.

We don't agree with that report, because they based their conclusions on 1 year's time. I believe the six companies they looked at also included two companies—Montana Power and Montana-Dakota—which have significant unusual regulatory problems, the confiscation-of-earnings-type problems, in that year. So, that group was, A, small, and had some special circumstances in it; and B, was only 1 year of time.

If you look at that group compared to other utilities in prior years, they substantially overperformed in terms of total performance.

Mr. **Rosenthal**. There are other observations, too, with respect to that. Because Merrill Lynch did another study, which comes to the conclusion that there is an increment in price-earnings ratio which has attached to diversified utilities.

I do know in our own instance, for some decades now, our price-earnings ratio has been at the high end, if not the highest, in the electric and gas group, and often in the electric-gas-and-telephone group.

CHANNELING PROFITS TO SHAREHOLDERS

Senator **D'Amato**. One final question.

Critics of repeal, or those who are concerned about the potential effects of diversification, indicate that the taxpayers or ratepayers would be funding diversified activities, while it's questionable how the profits of any of the nonutility businesses would benefit them.

Could you respond to that?

Mr. **Rosenthal**. I don't see how the ratepayers would be funding it, because every well-informed commission before which I've appeared—and that constitutes 10 of them—has the viewpoint that the only elements that are permitted in cost of service are those having directly to do with utility operations themselves.

If what the author of that observation means is that utilities may use their retained earnings to acquire nonutility endeavors, those retained earnings don't belong to the ratepayer in any sense of the word. Those retained earnings constitute a return on equity capital that has not been paid out in dividends and as such, is the property of the shareholders, not the property of the consumers.

Senator D'AMATO. So, you would argue that in terms of risk of capital, it is the capital of the stockholder, as opposed to any adverse impact on the ratepayer?

Mr. ROSENTHAL. Except in circumstances where a commission has directly and deliberately permitted a utility to fund, say, oil and gas exploration—and that has indeed been done, principally in gas—to fund the costs of gas exploration by an increment in rates, by including an allowance in cost of service for that purpose.

Senator D'AMATO. Gentlemen, let me thank you very, very much for your participation. I appreciate fully your points of view. It's too bad we couldn't continue this discussion—maybe we will have another hearing on this, and I would suspect that we will. I would focus it on your point of view, and those who are concerned in the area of diversification.

I would ask Mr. Rosenthal and Mr. Barr and Mr. Cabot--I would suggest that we may wish to invite you back, to speak specifically to those two issues.

Let me again express my deep appreciation not only to the witnesses and to those who have helped make these committee meetings possible, but also to a very competent staff and their work—Diane Sanger, in particular, and John Daniels, committee counsel—for making possible these hearings and informing one Senator as to the pitfalls that continually cropped up as we went along.

We stand in recess.

[Whereupon, at 11:40 a.m., the hearing was adjourned.]

[Additional material received for the record follows:]

environmental
action
foundation

724 Dupont Circle Building
Washington, DC 20036

Board of Directors

Walter Boardman
Gail Harmon
Lenneal Henderson
Katherine Hunninen
Richard Munson
Jerry Powell

Advisory Board

Harry Caudill
Herman Daly
Michael Frome
John Gofman
LaDonna Harris
Hazel Henderson
Odessa Komer
Sam Love
Amory Lovins
Victor Reuther

Projects

Administration (202) 659-0682
Electric Utilities (202) 659-1130
Waste and Toxic
Substances (202) 296-7570

June 8, 1982

Senator Alphonse D'Amato
Senate Committee on Banking,
Housing and Urban Affairs
Subcommittee on Securities
5300 Dirksen Building
Washington, D.C. 20510

Dear Senator D'Amato:

Enclosed please find a statement we have prepared regarding the Public Utility Holding Company Act of 1935. We request that you include our statement in the record of your subcommittee's hearings on this subject. I have enclosed five copies so that you may distribute the statement to the members of the subcommittee.

The twelve organizations sponsoring this statement are concerned about proposals to repeal or amend the Holding Company Act. We believe that the proper regulation of utility holding companies is essential to the protection of the public interest. We fear that a weakening of the Act could result in widespread overcharges of consumers through unregulated transactions between holding company subsidiaries. From an environmental standpoint, we are concerned that changes in the law might encourage utilities to increase their dependence upon strip mining and centralized power generation.

Thank you for considering our views on this important matter.

Sincerely,

Richard E. Morgan

Richard E. Morgan
Research Coordinator
Energy Project

environmental
action
foundation

724 Dupont Circle Building
Washington, DC 20036

Board of Directors

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UNITED STATES SENATE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

SUBCOMMITTEE ON SECURITIES

STATEMENT OF RICHARD E. MORGAN

regarding the

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

on behalf of

Consumer Energy Council of America

Consumer Federation of America

Environmental Action Foundation

Environmental Action, Inc.

Environmental Policy Center

Friends of the Earth

Natural Resources Defense Council

Nuclear Information and Resource Service

Public Citizen's Critical Mass Energy Project

Sierra Club

Solar Lobby

Union of Concerned Scientists

June 9, 1982

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Mr. Chairman and members of the Subcommittee, the above organizations wish to express their views on the subject of proposed changes in the Public Utility Holding Company Act of 1935. We are 12 separate national environmental and consumer organizations, representing a combined membership of 525,000.

We have joined together to prepare this statement because we are vitally concerned about preserving the Public Utility Holding Company Act. We are strongly opposed to repeal of the Act, which we believe would enable utility holding companies to use their peculiar corporate structures to overcharge consumers and deceive investors.

We believe the Holding Company Act is a well conceived piece of legislation which is as important today as it was 47 years ago. We have yet to see any proposed amendments which would improve on the existing law. In fact, the amendments proposed in the House and the Senate, we believe, would create giant loopholes for holding companies to take advantage of consumers and investors.

The Holding Company Act provides crucial protection to the general public. It prevents utility holding companies from abusing their monopoly privileges. And it keeps them from amassing the tremendous economic and political power which they wielded in the 1920s.

The paper empires, stock swindles, and sweetheart deals which chracterized the utilities of the 20s are largely a thing of the past thanks to the Holding Company Act. But to repeal this law during today's turbulent economic times would be inviting the utilities to abuse their investors and consumers once again.

The utility business in the United States is not a free enterprise; it is a monopoly. In exchange for the privilege of monopoly status, utilities must consent to regulation of their prices and business practices. The primary function of utility regulators is to prevent utilities from taking unfair advantage of their monopoly status by overcharging and otherwise abusing their customers.

A holding company is much more than a utility. Besides owning several separate utility companies in different states, a holding company might own a few coal mines, a railroad, and a "service company" which provides planning and engineering services to the other subsidiaries.

Regulation of holding companies poses some thorny questions for state utility commissions. Is a subsidiary utility paying a fair price for coal from a "captive" mine? Are the fees it pays to its service company for engineering services appropriate and necessary? Is the regulated portion of the holding company's business subsidizing other enterprises which must compete in free markets?

The potentials for conflicts of interest in a holding company structure are unending. When a holding company's utility service territories cross state lines, it is virtually impossible to regulate effectively at the state level. Since state regulators do not have access to all of the corporate records of a holding company's non-utility functions, they cannot be expected to protect from possible unfair business practices. Here, the Holding Company Act provides crucial protection by regulating transactions between affiliated companies under one holding company roof.

The possibility of such abuse is not just theoretical. Three major holding companies, American Electric Power, Middle South Utilities, and the Southern Company, each own fuel supply subsidiaries. In 1978, the Federal Energy Regulatory Commission (FERC) found that American Electric's captive coal subsidiaries were charging inflated coal prices to its utility operations resulting in overcharges to consumers. Captive coal abuses are a serious problem according to the FERC, which concluded in a February 1982 study that:

> "(1) Captive coal prices are on the average significantly higher than non-captive coal prices; (2) captive coal mines appear to be operating less efficiently than comparable non-captive coal mines; and (3) regulation of electric utility affiliated coal operations may be inadequate to assure the efficient management of captive mines and the reasonableness of captive coal prices."

In another example, the State of Illinois, just last month, sued People's Energy Corp., a diversified natural gas holding company, for conspiring to "drain" its utility subsidiaries to finance its profitable non-utility operations. Examples like these suggest that there is plenty of work for the staff at the Securities and Exchange Commission to do in enforcing the Holding Company Act.

State utility commissions are quite candid about their inability to properly regulate giant interstate holding companies. A recent resolution on the Holding Company Act adopted by the Executive Committee of the National Association of Regulatory Utility Commissioners (NARUC) states that "many state public utility regulatory commissions rely on provisions of the Act to assist in the effective regulation of electric and gas utilities within their jurisdiction." Under the Holding Company Act, for instance, the Securities and Exchange Commission regulates transactions between subsidiaries of registered holding companies, a power which state regulators lack.

Proponents of changes in the Holding Company Act maintain that the law stands in the way of utility efforts to diversify into non-utility businesses. Such diversification, they argue, can help to ease the financial difficulties experienced by utilities in recent years. The current law, however, does not prohibit all diversification into non-utility endeavors by holding companies. It simply protects investors and consumers from the risks of shaky and inappropriate investments by these utilities. If only federal regulators had had such foresight during the last years of another monopoly, the Penn Central Railroad.

In addition to regulating diversification by the 12 registered holding companies, the SEC may also look at diversification plans of any of the approximately 80 utilities which have previously been granted exemptions from registering under the Act. These utilities are seeking to amend the law to eliminate any possible federal intervention in their diversification schemes.

We wonder why such an amendment might be necessary. The current provisions give the SEC the right to investigate questionable diversification efforts by exempt holding companies. A company with a solid diversification plan should have nothing to worry about. Perhaps these utilities want to avoid federal intervention if they become overextended in diversified investments.

The potential risks of diversification demand careful oversight by regulators. Speaking on diversification, Don C. Frisbee, Chairman of Pacific Power & Light Co., a heavily diversified utility, has stated:

> "You can make more mistakes in new business . . . (I)t is a path that has more dangers than opportunities because of the difficulties of trying to mix a typical management approach to the highly regulated utility business with the entrepreneurial approach needed in unregulated arenas."

Moreover, as NARUC explains,

> "The stockholders of a utility may win or lose as a result to diversification but the consumer bears the risk of failure without any commensurate participation in the benefits of success."

Advocates of changes in the Holding Company Act argue that diversification may be a partial solution to the electric utilities' recent financial difficulties. But new figures from the industry and Wall Street indicate that this financial crisis is all but over. A survey by Ebasco Services indicates that the power companies received $9.5 billion in rate increases last year -- an all-time record. According to the Edison Electric Institute, 97 utilities announced dividend increases last year, and stockholder returns rose from 11.4 percent to 12.6 percent.

Under the Holding Company Act registered holding companies must comply with strict rules when issuing new securities, and the SEC may block questionable financing schemes. Some utilities argue that the law inhibits creative financing methods needed to raise capital in today's markets. But was it not "creative financing" that caused Samuel Insull's holding company empire to collapse in the 1930s? Fifty years ago, millions of investors and consumers suffered when the questionable financial dealings of the holding companies were exposed, a situation which led to the passage of the Public Utility Holding Company Act.

The repeal of the Holding Company Act would not only free the holding companies to pursue non-utility investments. It would also allow insurance companies, banks, and oil companies to freely go into the utility business, building power plants and other utility facilities. On the surface, this prospect might appear to give existing utilities a healthy dose of competition. That is unlikely, however, since each utility needs a monopoly market to sell its power.

More likely, non-utilities would participate with utilities in joint construction projects. Non-utilities might simply buy out some existing utilities, without the risk of being regulated as holding companies.

Just imagine utilities in your state being owned by Exxon or Mobil. Where would they buy their fuel? And how much would they pay for it?

The current law does not prevent non-utilities from becoming involved in the utility business. But if they choose to make large utility investments, they must face the same type of regulation which

Congress deemed necessary for any integrated utility holding company. Without these protections, we may see a recurrence of the far flung utility empires of the 1920s.

In conclusion, we believe that the Public Utility Holding Company Act is as important today as it was when it was written almost 50 years ago. This law protects consumers and investors, and it protects the utilities from themselves.

Even slight changes in the Act should not be taken lightly. Solomon Freedman, a 30-year veteran at the SEC, has observed that the Holding Company Act is an "integrated statute" and that altering any section could affect the authority of the entire law.

Citing their alleged financial crisis, the utilities say they must be freed from the restrictions of the Holding Company Act so they can pursue new business opportunities. The growing trend toward utility diversification is all the more reason why we need the Act. As the utilities diversify and find new ways to attract capital, we need these protections to make sure we are not led again down the same path as before.

STATEMENT OF
KARL BEROLZHEIMER
VICE PRESIDENT AND GENERAL COUNSEL
CENTEL CORPORATION
TO THE SECURITIES SUBCOMMITTEE OF THE SENATE BANKING COMMITTEE IN CONNECTION WITH S.1869, S.1870, S.1871 AND S.1977

Centel Corporation (prior to April 30, 1982 known as Central Telephone & Utilities Corporation) hereby conveys its support for repeal of the Public Utility Holding Company Act of 1935 (chapter 687, title I, 49 Stat. 803, as amended, codified at 15 U.S.C. 79 to 79z-6, 1976, hereinafter called PUHCA). Although Centel is neither a registered public utility holding company nor an exempt public utility holding company under PUHCA, it is affected by the existence of PUHCA. Its experience with PUHCA results in a strong conviction that PUHCA is obsolete, structurally rigid and of no value to the public.

Centel has been engaged in business as a telephone, electric and gas utility in various states since 1935. Until 1978 all of its operations were regulated by state or Federal regulatory authorities. In 1976 the last of its gas utility properties were sold. Since 1978 Centel has acquired a number of unregulated businesses all of which are communications related. Centel considers itself a communications company. However, Centel continues to own electric utility properties.

Centel's electric utility properties are located in Colorado and Kansas and serve 131,869 customers. In 1981 electric revenues were less than $139 million and represented less than 14% of Centel's total revenues.

Centel's largest business activity is providing local telephone service in 10 states. Telephone revenues in 1981 amounted to more than $634 million or 62% of total revenues.

Centel also engages in several unregulated business activities including cable television, sale of business communication systems, distribution of telecommunications supplies and miscellaneous manufacturing. The unregulated business segment contributed more than $247 million or 24% of Centel's revenues in 1981.

Centel's telephone operations are regulated by the state utility commission in each state in which it operates. Such regulation includes service area certification, rate setting, depreciation schedules, service standards, accounting and securities issuance. The Federal Communications Commission (FCC) also exercises jurisdiction over Centel's telephone operations with respect to radio licenses, connection to the interstate telephone network and customer premises equipment.

Centel's electric operations are subject to pervasive regulation by the Colorado and Kansas utility commissions and by the Federal Energy Regulatory Commission with respect to wholesale service. This regulation also includes service area certification, rate setting, depreciation schedules, service standards, accounting and securities issuance. FCC also regulates Centel's use of radio licenses.

Centel operates as a three tiered holding company. Centel, as the parent company, is the only company in the Centel System which has common stock publicly held. Its common stock is listed on and subject to the rules of the New York and Midwest stock exchanges.

In addition, Centel has outstanding preferred stock, bonds and debentures which are held by the public and have been registered under the Securities Act of 1933. It is a reporting company under the Securities Exchange Act of 1934.

Centel's second tier subsidiaries include three telephone companies each of which has issued long-term debt to institutional holders. One of them, Central Telephone Company, has also registered securities under the Securities Act of 1933 and is a reporting company under the Securities Exchange Act of 1934. Centel Communications Company is a subsidiary which engages in unregulated operations.

The third tier consists of four subsidiaries of Central Telephone Company each of which is a telephone company which operates in one state and is subject to utility regulation in that state. Three of these subsidiaries have registered securities under the Securities Act of 1933 and are reporting companies under the Securities Exchange Act of 1934. Central Telephone

Company itself operates telephone properties and is subject to utility regulation in four states.

Centel Communications Company also has a number of third tier subsidiaries. The operations of Centel Communications Company are not subject to utility regulation and it has not issued any securities. However, cable television subsidiaries are regulated in varying ways by municipal franchising authorities. They are also subject to FCC jurisdiction with respect to radio licenses. Centel Communications may sell securities in the future and become subject to covenants imposed by lenders and securities laws.

Additional protections which apply to Centel, as well as to all other publicly held utility companies, include:

(a) accounting standards, such as business segment reporting, promulgated by the Financial Accounting Standards Board and the Securities and Exchange Commission;

(b) investment banking industry review and publication of analysts' reports and recommendations;

(c) regulatory proceedings, which now commonly include management and accounting audits and participation by public counsel designed to prohibit cross-subsidization among different products and services; and

(d) application of Federal and state antitrust laws to utilities.

The purpose of the foregoing recitation is to demonstrate that Centel operates as a holding company with several layers of subsidairies. It is a leveraged enterprise. However, it is subject at nearly all levels to utility regulation and securities law requirements and disclosure which provide adequate protection to the public.

A public utility holding company under PUHCA is a company which owns a retail gas or electric utility subsidiary. Centel is not a public utility holding company under PUHCA because its electric properties are owned by the parent, Centel. If the electric properties were owned by subsidiaries, Centel would be a public utility holding company. This is an artificial distinction which has no economic significance. By placing its electric properties at the top of its corporate structure, Centel has avoided PUHCA. This has, however, created internal organization and accounting problems which could be avoided if the electric properties were held as subsidiaries.

It has been important to Centel to be free of the constraints of PUHCA in the face of the revolutionary changes taking place in the telephone industry. Telephone operations are experiencing declining rate base due to several forces including deregulation of customer premises equipment. Competition in the intercity market and a shift in revenue requirement from intercity to intrastate, coupled with the loss of rate base, is creating a downward pressure on revenue. Utilizing its human and capital resources, Centel has acquired communications related businesses to generate revenue in the future and maintain its financial integrity. It could not have done so as a registered public utility holding company or as an exempt public utility holding company.

During the past year Centel has been studying whether to sell its electric properties. In that connection it has considered whether to place its electric properties in one or more subsidiaries for sale or for the future if not sold. There would be certain corporate and tax advantages to selling a corporate subsidiary rather than selling assets. However, we were advised that because of PUHCA:

1. Centel could not have two electric subsidiaries.

2. If a subsidiary were established in Colorado, an exemption would be granted under Section 3(a)(2) of PUHCA (15 U.S.C. §79c(a)(1)).

3. A transitory subsidiary could be created for sale without an exemption but only for a very short period.

4. A subsidiary could not be established in Kansas until the Colorado properties were sold but then a Kansas subsidiary could be created with an exemption

under Section 3(a)(1) of PUHCA (15 U.S.C. §79(c)(a)(2)) but only so long as Centel and the subsidiary were both Kansas corporations.

5. The Kansas properties could not be sold before the Colorado properties but both could be sold at the same time and Colorado could be sold before Kansas.

6. One subsidiary would probably not be allowed to operate in both Colorado and Kansas. (This is ironic since Centel itself is doing so.)

We believe this analysis demonstrates that PUHCA creates obstacles in an artificial, arbitrary manner unrelated to current public, corporate or utility needs. The application of PUHCA is in many respects based upon the fact that Centel is a Kansas corporation, which should be irrelevant. Centel is not a registered public utility holding company and it does not have a complex structure. It cannot act with respect to its electric properties without the approval of two state and two federal regulatory commissions. Yet PUHCA overhangs and hampers its plans.

Even exempt holding companies have been subject to review by the SEC of issuance of debt securities. Generally they have been prohibited from issuing convertible debentures or other forms of senior securities. The vague statutory standard is set forth in Section 11(a) of PUHCA (15 U.S.C. §79k(a)) which directs the SEC to review the corporate structure of every registered holding company "to determine the extent to which the corporate structure of such holding-company system and the companies therein may be simplified, unnecessary complexities therein eliminated..." Section 7(d)(1) of PUHCA (15 U.S.C. §79g(d)(1)) provides that the SEC may allow a registered holding company to issue securities unless it finds "the security is not reasonably adapted to the security structure of the declarant and other companies in the same holding-company system..." Utilities should be allowed to utilize the many forms of financing which have evolved since 1935. Statutory standards simply deprive the utilities and their customers of the lowest cost money available.

A further problem with PUHCA is that it applies without regard to the size of a company's utility operations. As noted earlier, Centel's electric operations account for less than 14% of its revenues. Yet this small segment of Centel's business could subject it to PUHCA and causes Centel to organize itself in a way it would not otherwise choose.

Centel respectfully suggests that PUHCA has outlived its usefulness and provides no meaningful safeguard for the public. Other controls, including utility regulation and securities laws, adequately protect the public from the abuses PUHCA was designed to address. PUHCA elevates form over substance to a degree which causes it to inhibit realistic organizational and financial structure. Accordingly, Centel urges that PUHCA be repealed.

Respectfully submitted:

CENTEL CORPORATION

By
Karl Berolzheimer
Vice President and General Counsel

June 17, 1982

STATEMENT OF THE
AMERICAN IRON AND STEEL INSTITUTE
TO THE
SUBCOMMITTEE ON SECURITIES
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
REGARDING PROPOSALS TO MODIFY OR REPEAL
THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

The American Iron and Steel Institute (AISI) is pleased to submit the following statement of position regarding current efforts to repeal or modify the Public Utility Holding Company Act of 1935 ("PUHCA"). That Act provides a federal regulatory scheme that imposes certain restrictions on the financial and diversification activities of utility holding companies and their affiliates in recognition of the franchised monopoly power that they wield.

AISI is the principal trade association for the steel industry. Its 64 domestic member companies (who are listed in Appendix A) account for approximately 91 percent of the raw steel production capability in the United States. These AISI member companies use, in the manufacture of steel, about three percent of all the energy consumed in the United States. During 1981, AISI member companies and other steel producers purchased 43.6 billion kilowatt hours of electricity. AISI thus has a significant interest in promoting the development of and adoption of coordinated, rational and consistent

Federal policies which will assure an adequate, reliable and efficient electricity supply for all users at prices based upon the costs incurred in serving those customers.

Because electricity is the most expensive form of energy purchased by AISI members, and because newer steel-making processes are increasingly electricity-intensive, AISI believes that it is imperative that Congress consider the impact of any changes in PUHCA on the utility ratepayer before it repeals or materially modifies PUHCA. Thus far, the debate seems to have focused primarily upon the arguments advanced by the utility company advocates of repeal or modification. While AISI shares the interest of all companies in eliminating unnecessary or duplicative regulatory burdens, it does not believe that that is the key issue here. The key question confronting Congress regarding PUHCA is whether electric utilities can be regulated without PUHCA in a way that will prohibit such utility monopolies from forcing their captive customers - AISI members and all other utility ratepayers - to pay for benefits going to others.

Because AISI does not believe that this question has been adequately analyzed from the perspective of ratepayers, it submits that the Congress should not take any action this Session to repeal PUHCA but instead should (1) continue to study this and related issues, (2) review carefully the NARUC Ad Hoc Committee Report on Utility Divsersification, due in late July, and (3) request that the GAO or the CRS conduct an analysis of the extent to which portions of PUHCA are duplicative or unnecessary in the light of other federal statutes, existing state laws, and current economic realities confronting electric utilities and steel companies alike.

With these further reports and studies in hand, the Congress - probably in the next Session - would be in a position to take action on PUHCA. The challenge then would be to modify the 1935 Act in a way that still recognizes the basic concerns that led to its passage but meets those concerns with as flexible and light-handed a regulatory framework as possible.

In support of its position opposing repeal of PUHCA at this time, the AISI submits the following:

1. Advocates of repeal emphasize that federal regulation by the SEC is unnecessary since state regulators have sufficient authority and are there to prevent monopoly abuses of power by electric utility holding companies. AISI disagrees with this analysis, on at least four grounds, as follows:

    a. Existing federal and state securities laws, and their regulation, relate to the protection of stockholders, and investors. Here, our focus must be the protection of monopoly ratepayers.

    b. Even if state PSC's have the authority to approve financing by operating utilities within their States, an interstate holding company can probably evade this regulation by raising funds through the holding company.

At present, SEC reviews all financings by the holding company. A reasonable requirement would be to continue to require that holding companies file their investment plans with the SEC, but that approval of those plans be automatic unless an affected State objects to the company's diversification program. If some states approve and others object, the SEC would decide as the Federal arbiter.

c. Absent a centralized record-keeping activity within the SEC for interstate utility holding companies, AISI does not see how state regulators will be able to achieve effective access to a holding company's books. This is important, because different decisions by different states may have implications for the capital structure to be used for rate-setting purposes, and PSC staffs need to be able to inspect the records of affiliates to insure that transactions between the utility and holding company affiliates do not harm ratepayers.

d. Without some broad, over-all review of the scope of a utility's diversification plans, preferably by the SEC, ratepayers will have no assurance that the regulated utility side of the business remains a significant fraction of the whole so that state PSC actions get the attention of the holding company. As AISI sees it, the "hearts and minds" of utilities will follow state PSC desires only to the extent the utility operation of the holding company remains a significant enough part of the holding company's total operations. This is why a periodic overview of the utility's broad strategic diversification plans by either the SEC or FERC is so important. Moreover, AISI is not sanguine that state PSCs have the resources, the expertise, or the ability to take over in an area where they have heretofore relied upon federal government regulation, and where, if PUHCA were repealed, the federal government had pulled out.

2. Some proponents of repeal have suggested that the Congress would be able to fill the regulatory gap using its oversight function. However, AISI believes that since Congress cannot perform the kind of in-depth company-by-company auditing that is essential to assure that the interests of ratepayers are adequately protected, it wisely delegated that power to an expert regulatory body, the SEC. That is where it should remain, albeit in as flexible and light-handed regulatory framework as possible.

3. Whether repeal of PUHCA will enable utilities to improve their overall financial condition is far from clear, but what is clear is that if a diversification venture succeeds, the stockholder will benefit, and _if_ there is no cross-subsidization the rate-payer won't be penalized. If on the other hand the new venture fails, or if there is cross-subsidization, the ratepayer has borne involuntary risks and may pay involuntary penalties.

Also, it seems to AISI that the "financial plight" cry no longer has the validity it once did. It now applies, regrettably, to the steel industry.

4. While PUHCA does require utilities subject to it to do significant planning, it has not prevented them from making acquisitions that are consistent with their purpose as utilities.*/ The nine electric utility holding companies own sixty utilities which represent 20% of the U.S. industry with assets of nearly $50 billion and revenues of $17 billion. Thus while the price of PUHCA regulation may be regarded by some of those subject to it as too high, from the perspective of ratepayers it does not seem out of proportion to the benefits granted by the franchise each utility enjoys.

5. To suggest that no one will be hurt by repeal is disengenuous. It is possible that AISI members' electric bills could increase in any number of ways : failure of the diversified venture, inappropriate transfer pricing, improper allocation of common utility and non-utility costs, and possible spin-off of a utility system, or take-over of a utility or its holding company by a U.S. or non-U.S. firm.

Conclusion

For the foregoing reasons, AISI opposes repeal of PUHCA at this time. AISI believes that its position is not inconsistent with the thrust of the revised Administration position to stay the effective date of any repeal legislation for two years to give states time to consider additional legislation.

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*/ Even this kind of diversification, however, is of concern to the Justice Department, but nonetheless Mr. Baxter concluded that PUHCA should be repealed. (Testimony, June 8, 1982).

APPENDIX A

American Iron and Steel Institute

Domestic U.S. Company Members

Allegheny Ludlum Steel Corporation
AL Tech Specialty Steel Corporation
American Cast Iron Pipe Company
Armco Inc.
Atlantic Steel Company
The Babcock & Wilcox Company
Bekaert Steel Wire Corporation
Bethlehem Steel Corporation
Bristol Metals, Inc.
Carpenter Technology Corporation
CF&I Steel Corporation
Charter Manufacturing Company, Inc.,
   Charter Rolling Division
The Cleveland-Cliffs Iron Company
[illegible]
Columbia Tool Steel Co.
Consolidated Metals Corp.
Continental Copper & Steel Industries, Inc.
Copperweld Corporation
Cyclops Corporation
Electralloy Corporation
A. Finkl & Sons Co.
Florida Steel Corporation
[illegible]
[illegible]
Green River Steel Corporation
Guterl Special Steel Corp.
The Hanna Mining Compnay
Harsco Corporation
Ingersoll Johnson Steel Company
Inland Steel Company
Intercontinental Metals Corporation
Interlake, Inc.
Jessop Steel Company
Jones & Laughlin Steel Corporation
Earle M. Jorgensen Company
Joslyn Stainless Steels, Division of
   Slater Steel Inc.
Kaiser Steel Corporation
Keystone Consolidated Industries, Inc.
Korf Industries, Inc.
Laclede Steel Company
Lone Star Steel Company
Lukens, Inc.

McLouth Steel Corporation
National Steel Corporation
North Star Steel Company
Northwestern Steel and Wire Company
Oglebay Norton Company
Oregon Steel Mills, Division of
  Gilmore Steel Corporation
Phoenix Steel Corporation
Pickands Mather & Co.
Raritan River Steel Company
Republic Steel Corporation
Roblin Industries, Inc.
Rome Strip Steel Company, Inc.
Sandvik, Inc.
Sharon Steel Corporation
Sharon Tube Company
Shenango Incorporated
Teledyne Columbia-Summerill, Division of
  Teledyne Industries, Inc.
Teledyne.Vasco, Division of
  Teledyne Industries, Inc.
The Timken Company
Union Electric Steel Corporation
United States Steel Corporation
Valley Mould & Iron Company
Washington Steel Corporation
Wheatland Tube Company
Wheeling-Pittsburgh Steel Corporation

STATEMENT OF THE
ELECTRICITY CONSUMERS RESOURCE COUNCIL
TO THE
SUBCOMMITTEE ON SECURITIES,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
UNITED STATES SENATE
REGARDING PROPOSALS TO MODIFY OR REPEAL THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

ELCON

The Electricity Consumers Resource Council (ELCON) is pleased to submit the following statement to the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs. The purpose of this statement is to present ELCON's views on current efforts to modify or repeal the Public Utility Holding Company Act of 1935. This Act places certain restrictions on the financial and diversification activities of utility holding companies and their affiliates, and as such has an important impact on utilities and their customers.

ELCON is a group of seventeen large industrial consumers of electricity with facilities in most of the fifty states.1/ ELCON advocates and promotes the development and adoption of coordinated, rational and consistent federal, state and local policies which will assure an adequate, reliable and efficient electricity supply for all users at prices based on the costs incurred in serving customers.

ELCON's members consume approximately ten percent of all electricity sold to industrial customers and nearly five percent of all electricity sold in the U.S. Because of our members' use of electricity, ELCON has a significant, continuing interest in the electric utility industry, and we appreciate the opportunity to comment on this important regulatory issue.

1/ ELCON members are: Air Products and Chemicals, Inc.; Airco, Inc.; Anheuser-Busch Companies, Inc.; Armco; Bethlehem Steel Corporation; Diamond Shamrock Corporation; E.I. du Pont de Nemours & Company; FMC Corporation; General Motors Corporation; Kaiser Aluminum & Chemical Corporation; LCP Chemicals & Plastics, Inc.; Nabisco Brands U.S.A.; Olin Corporation; PPG Industries, Inc.; Stauffer Chemical Company; Union Carbide Corporation; and United States Steel Corporation.

ELCON's members support the efforts of the Reagan Administration's regulatory relief task force, chaired by Vice President Bush, to identify federal laws and regulations that impose excessive burdens on business, individuals, and state and local governments, and to identify ways to alleviate these burdens. In appropriate cases, ELCON has supported the repeal or modification of federal laws or regulatory programs affecting electricity.

Summary:

Although we support regulatory reform efforts where appropriate, ELCON opposes efforts to repeal the Public Utility Holding Company Act of 1935 (PUHCA or Act). ELCON believes that those who support such action should consider the possible effect that repeal of the PUHCA might have on the Nation's electric utility customers.1/ Evidence that substantial portions of the Act are duplicative of other federal or state authority, that the problems which brought about its enactment will not reappear upon repeal, and that the protection provided by the Act is either no longer necessary or is adequately provided for by other statutes needs to be considered. ELCON stands ready to support modification or repeal of those portions of the Act that are shown to be duplicative or unnecessary.

Discussion:

ELCON's analysis of the PUHCA indicates that some of its major provisions remain relevant to today's economic circumstances. The fact that a major restructuring of the utility industry has been accomplished under authority of the Act is not convincing that past practices may not reappear absent oversight. It also seems apparent that other regulatory authorities (e.g.,

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1/ ELCON recognizes that the provisions of the PUHCA apply to both gas and electric utility holding company systems. However, our interest in the current proceeding applies only to the electric utility industry. Therefore, our comments on the proposed legislation are limited in applicability to the electric utility industry.

the Federal Energy Regulatory Commission and state public utility commissions), whose major purpose is to deal with ratemaking matters, simply do not have the necessary authority and/or expertise to effectively scrutinize the other financial aspects of interstate utility operations.

During testimony before both Senate and House Subcommittees, it was asserted by those advocating repeal or substantial amendment to the PUHCA that the financial health of utilities was closely related to diversification and, in turn, diversification depended on repeal of the PUHCA. We do not agree with those presentations. The financial health of the industry does not hang on the issue of diversification, and diversification does not depend upon repeal of the PUHCA.

ELCON's concern with repeal is based on the fact that the consequences of repeal cannot be documented. True, in forty-seven years since the passage of the Act the industry has not demonstrated any serious recurrence of the problems associated with the industry in the 1920's and 1930's. One can argue, as some do, that therefore the Act is no longer necessary. More objectively, it can be argued that the Act has been in effect for forty-seven years and that is why the previous abuses have not reoccurred.

Whether the "pyramiding" to which the Act was largely addressed will reappear after repeal is to a large extent conjecture. It would not be logical to assume the utility industry seeks repeal in order to return to the days of highly leveraged, holding company "pyramids." Uncertainty, high interest rates and precarious financial circumstances are not the stuff of which pyramids are built. We do not, therefore, question the utility industry's motives in this regard. We do question what regulatory oversight would remain, after repeal, to deal with interstate utility holding company financial issues.

We would much prefer a streamlined federal statute stripped of regulatory redundancies that maintains adequate oversight of the industry's structure. Absent the PUHCA, responsibility for overseeing the development of the industry structure will fall largely on state bodies. There is little consistency among the states, and even worse, lack of jurisdiction in interstate matters.

Thus, the question reduces to the gains and losses for all parties from a repeal of the PUHCA.

It does seem clear that registered holding companies are subject to regulation of their securities activities to an extent that impairs their ability to offer the lowest cost product to their customers. In addition, the ability to diversify is somewhat impaired by the PUHCA. Though we reject the notions that diversification is not possible under PUHCA and that diversification will have a substantial effect on utility financial health, nevertheless, we see no reason for the additional restrictions on financing opportunities for utilities operating under the holding company device. Repeal or modification could offer increased diversification opportunities to registered and exempt holding companies.

The claim is made that utilities will enjoy improved credit standing in the eyes of investors if permitted broader diversification opportunities. Such improvement, it is claimed, will lower the overall cost of capital to the utility entity. There also remains, however, the possibility that the utility status will attract capital while the risk of diversification will be shifted to consumers from stockholders. This argument is tied to the diversification issue more that to repeal of the PUHCA. We are not convinced that any generalizations are possible a priori about the impact of repeal, other than the hopes expressed about the effect of diversity on the cost of capital. No doubt the effect will be substantially different for different utilities. To the extent that generalizations are unconvincing one way or the other ELCON feels no real confidence should be placed on assertions regarding the impact of repeal on utilities' cost of capital.

Perhaps the most telling criticism of the PUHCA is the seemingly contradictory principles involved in regulation of registered vs. exempt holding companies. The pervasive security regulation under PUHCA of registered companies does not apply to exempt holding companies. The fact that registered companies operate over state lines while exempt companies are confined largely to intrastate operations does not seem at present to be a compelling reason for such extraordinary regulation of registered company security activity. Both types of companies are subject to the 1933 and 1934 Securities Acts, so additional restrictions on registered holding company financial activity does not seem warranted.

The argument as to the possible conflict of interstate and intrastate regulation leaves ELCON with residual concern regarding the ability of state commissions to adequately supervise the relationship between interstate, diversified holding company operations. We do not, however, wish to translate that concern into a larger than life fear of consequences for utility customers or stockholders. We simply do not know how state legislatures and state commissions will respond to the potential gap in oversight. Contrary to assertions made by some, all state PUC's do not currently have the authority to deal with financial transactions within holding company systems. Illustrative of the kind of state legislation that would be encouraged by repeal of the PUHCA is the bill enacted by the New Mexico legislature at the end of its session this past February. That bill imposes a 15-month moratorium on utility diversification into non-utility related business, directs further legislative study of diversification, and mandates the state PSC to come up with a rulemaking on the same issue by November 30, 1984. The Wisconsin PSC is in the process of promulgating regulations regarding utility diversification, and the Maine legislature passed and the Governor signed a bill that gives the Maine PUC jurisdiction over the setting up of utility holding companies in that state. Similarly, state legislatures would doubtlessly feel motivated to re-examine their statutes (if any) applicable to transactions between public utilities and their affiliates. Today, some are explicit, some are general, and in some cases there is no relevant statutory provision.

Finally, it is claimed that exempt holding companies view the possibility of revocation of their exemption under the Act as a continuous and possibly arbitrary threat. We certainly agree that regulation should not be capricious or arbitrary. Repeal would, of course, remove the somewhat artificial difference between registered and exempt holding companies but, as we have stated earlier, this gain in symmetry is offset by the uncertainty in oversight, since the states may act in a manner that creates rather than cures uncertainty.

If the Act is repealed we think the recommendation of Dr. Richard E. Schuler, Deputy Chairman of the New York PSC, testifying on behalf of NARUC, has merit. He suggested that in the event of passage of a repeal bill or modification to the PUHCA, the effective date of the legislation should be no sooner than 12 months after passage. This would allow time for states to consider and implement their response to the federal action.

Conclusion:

Although ELCON opposes repeal of the PUHCA, it is sympathetic to utility concerns regarding unnecessarily expensive and burdensome regulation. Accordingly, to the extent that any reporting requirements and layers of regulatory review and oversight imposed by the PUHCA are duplicative of other federal or state regulatory requirements or are unnecessarily burdensome, ELCON agrees that a strong case is made for modification of the Act. Indeed, the recodification and simplification of the PUHCA prepared by the American Law Institute in 1975 should be considered by the Congress as one alternative in its review of what provisions of the Act should be retained in the 1980's and beyond.

The Congress might also consider a transfer of the SEC's responsibility under the PUHCA to the FERC. The rationale for this transfer of authority would be that if administration of the PUHCA was assigned to the FERC, better integration of all regulatory responsibilities relating to public utility holding companies could be achieved by one federal agency.

ELCON has attached to this statement its analysis of the PUHCA.

ELCON

THE PUBLIC UTILITY HOLDING COMPANY ACT
AND ELECTRIC UTILITY DIVERSIFICATION

JUNE 1982

Electricity Consumers Resource Council
1828 L Street, N.W., Suite 403
Washington, D.C. 20036
(202) 466-4686

EXECUTIVE SUMMARY

Efforts are currently underway which call for substantial modification or repeal of the Public Utility Holding Company Act of 1935 (PUHCA or Act). Several bills have been introduced in Congress, and the electric utility industry has initiated a campaign seeking modification or repeal of the Act and is developing a strategy for increased efforts in electric utility diversification into nonutility-related activities.

The utility holding company act was enacted in 1935 to correct abuses of the holding company device and to promote effective state regulation. At that time, 13 large holding companies controlled approximately three-fourths of the privately-owned electric and gas utilities in the United States. Abuses which the Act was designed to correct include inadequate disclosure of financial information, unsound financial and corporate practices, excess charges to utilities for services provided by subsidiaries, extension of holding company systems without regard to economics of operation or integration of facilities, and obstruction of effective state regulation.

The provisions of the Act empower the Securities and Exchange Commission (SEC or Commission) to confine a utility holding company to a single integrated system, simplify financial structures of registered holding companies, prevent unsound business practices, require all services provided by affiliated companies to be provided at cost properly allocated, require SEC approval of acquisition of other utilities, prohibit the use of funds derived from utility securities to finance nonutility ventures, restrict intercompany loans, dividends, security transactions, sale of utility assets, solicitation of voting proxies, and political contributions. Section 3 of the Act also provides for SEC exemption of utility holding companies from most of the provisions of the Act, based primarily upon geographic integration of the company, and subject to SEC revocation.

Restructuring of the utility industry and simplification of its financial structure have substantially been completed under authority of the Act. Several major investigations of the PUHCA and its administration by the SEC have found that its authority under the Act is largely nonduplicative of other federal or state statutes. There is, however, some question as to the continued need for SEC restrictions on registered holding company security issues.

State regulatory commission authority to control financial and diversification activities of jurisdictional utilities is limited and diverse. State commissions are primarily concerned with ratemaking issues and have limited authority over utility investment in nonutility activities, particularly when these are located in another state.

Considerable diversification by electric utilities has taken place, largely in areas related to utility operations, even with the PUHCA in force. Most utility holding companies have received exemption from most provisions of the Act, under Section 3 authority. There is some concern that the SEC has applied its exemption powers too broadly, resulting in uneven regulation of the industry.

The main benefit to be derived from expanded electric utility diversification is alleged to be the improved financial position of the industry. The available evidence, however, indicates that utility diversification into nonutility activities may contribute to the long-term problems of the industry rather than improve them. Inadequate returns to utility investment should be dealt with directly through the granting of rate relief rather than indirectly through diversification activities.

Substantial utility diversification into nonutility activities poses potential problems for state regulators in such areas as protection of the utility and its customers from unsuccessful nonutility activities, separation of utility and nonutility costs and revenues, determination of the utility's cost of capital, and possible misuse of utility funds and assets. Regulators need to prevent potential financial and operating abuses rather than deal with them after they happen. To this end, continued surveillance of the industry, as provided for in the PUHCA, may be required to protect the public interest.

In light of the available information, ELCON should oppose repeal of the PUHCA, unless explicit evidence is presented to show that the authority of the Act is substantially duplicated by other federal or state authority. However, modification of the Act, particularly those parts that place restrictions on registered holding company financings, may be in order. Electric utility diversification into related areas of operation has taken place and should not be discouraged. We are convinced that substantial diversification into unrelated activities is problematical as a substitute for effective state regulation.

ELCON

I. INTRODUCTION

There has been much interest recently in the Public Utility Holding Company Act of 1935 and its effect on electric utility company diversification activities. There are currently several bills pending before Congress to modify or repeal the Act.[1] The electric utility industry has mounted a campaign calling for modification or repeal of the Act and is developing a strategy for increased electric utility involvement in diversification activities.

As consumers of large amounts of electrical energy, industrial customers have a major interest in the possible effects of a significant change in federal regulation of the electric utility industry. ELCON and its members need to be aware of the possible effects of modification or repeal of the PUHCA on the availability of electric energy.

There are many questions pending about the continued need for the Act, on the reasons for its enactment, duplication of other state and federal authority, its effect on electric utility diversification activities, and the ability of state regulators to effectively regulate diversified, multijurisdictional utilities in the absence of the Act's authority. The purpose of this report is to provide background information and analysis of these and other issues as they relate to the PUHCA and electric utility diversification, and to determine if there is a need for an ELCON position regarding possible modification or repeal of the Act.

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[1] Senators Alfonse D'Amato and J. Bennett Johnston have introduced Senate bills S. 1869, S. 1870, and S. 1871, all of which are intended to modify certain provisions of the PUHCA. Representative Tom Corcoran has introduced bill H.R. 5220 which is similar in nature to the various Senate bills, and Senator Johnston and Representative Tauzin have introduced bills S. 1977 and H.R. 5465, respectively, which would repeal the Act in its entirety.

II. THE ISSUE

The issue to be considered by ELCON is: Should the PUHCA be modified or repealed to allow further diversification of electric utility companies into activities heretofore prevented or restricted by provisions of the Act? The electric utility industry is interested in intensifying its diversification activities into areas both related and unrelated to electric power production, and cites provisions of the Act which prevent or inhibit it from doing so. The reasons for the industry's increased interest in this area include: alleged increase in risks associated with electric utility operations; inadequate returns to operations due to inadequate rate relief and regulatory neglect; and little likelihood of sustained growth in industry sales or revenues for the foreseeable future.[2]

As a result, the industry is seeking to expand its activities into other areas of operation as a means to increase the potential for future sales and revenue growth. It is felt that funds invested in nonutility operations have a greater potential for achieving adequate returns since these investments are not subject to the direct control of regulatory commissions.[3] Diversification may also provide a rate of growth in earnings not available to electric utility operations.

It is hoped that increased diversification will lead to geographic and customer diversity and will improve the financial community's evaluation of industry earnings. This, in turn, will improve utility company price/earning ratios, decrease the industry's cost of capital, and improve its market-to-book ratio and its bond coverage ratio. However, utilities must be assured that profits resulting from investments in nonutility activities are not subject to state or federal regulatory commission control; hence, the industry's interest in modifying or repealing the PUHCA.

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[2] "Business Diversification: A Strategic Option for U.S. Investor-Owned Utilities," by Terry Ferrar, *Management Review*, November 1981, pp. 13-23.

[3] *The Electric Utility Industry: The Future is Taking Shape*, by E. J. Tirello, Jr. and S. Fedun, Lehman Brothers Kuhn Loeb Research, New York, November 1981.

State regulators point out the unique characteristics of the electric (and other) utility industry that led to its regulation in the first place.[4/] They point to the fact that utilities furnish services generally considered to be essential to the public and of critical importance to the nation's economic infrastructure. They also mention that these services are provided through investments that are much more capital intensive than most other industries and that utilities are obligated to provide service to all customers and must attract large amounts of capital to ensure adequacy of supply. Also, utilities operate as franchised monopolies, that is, this critical service is provided by only one company in a particular service territory and utilities require the use of streets and highways and the power of eminent domain to carry on their activities.

As a result of these unique characteristics, utilities are subject to state and federal regulation — including the PUHCA — designed to protect the public while providing adequate financial returns to the industry. Moreover, regulators must assure that the industry does not circumvent effective regulation nor jeopardize its ability to provide adequate service at reasonable prices by engaging in activities beyond the purview of state and federal regulatory agencies. As a 1972 report on nonutility investments pointed out:

[4/] 1972 Report of the Ad Hoc Committee on Non-Utility Investments, National Association of Regulatory Utility Commissioners, Eighty-Fourth Annual Convention, Washington, D.C., November 1972.

The maintenance of assured public utility financing is of such critical importance that every effort should be made to sever public utility operations from non-public utility operations, particularly where the latter are substantial in scope... The threats posed by extensive utility diversification are neither new nor illusory. Indiscriminate diversification by public utilities was one of the factors underlying passage of the Public Utility Holding Company Act of 1935... The current emphasis in regulatory circles is on taking preventive measures, rather than waiting for a crisis before taking action. Regulatory officials would be justly subject to criticism if ... appropriate measures were not taken to protect the critical function of public utility financing from possible impairment resulting from uncontrolled diversification. 5/

5/Ibid., p. 721.

III. THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

Conditions That Led to Enactment

According to the Securities and Exchange Commission, the PUHCA was adopted in response to the control exercised by a relatively few large financial corporations of a major part of the gas and electric utility industry.[6] In 1932, thirteen large holding companies controlled three-fourths of the privately-owned electric and gas utility companies, with about 45 percent of ownership concentrated within the three largest holding companies. The SEC notes that this situation was aggravated by the unsoundness of utility holding company financial structures and the lack of meaningful economic or operational relationships among the constituent parts of holding company systems. It also notes that the Congress was particularly concerned that the effectiveness of state regulation of utility systems was seriously impaired by such use of the holding company device.

Section 1 of the PUHCA mentions a number of abuses which the Act was intended to correct. These are:

(1) Inadequate disclosure to investors of the information necessary to appraise the financial position and earning power of public utility holding companies.

(2) The issuance of securities against fictitious and unsound values.

(3) The overloading of operating companies with debt and fixed charges.

(4) The imposition of excess charges upon operating companies for various holding company supplied services.

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[6] *Comments of the Securities and Exchange Commission on the Comptroller General's Report of June 20, 1977, to the Congress on the Administration of the Public Utility Holding Company Act of 1935*, Securities and Exchange Commission, Washington, D.C., 1977, p. 1.

(5) The control by holding companies of the accounting practices and rate, dividend, and other policies of their operating subsidiaries so as to complicate or obstruct state regulation.

(6) The control of subsidiary holding companies and operating companies through disproportionately small investment.

(7) The extension of holding company systems without relation to economy of operations or the integration and coordination of related properties.

Major Provisions of the PUHCA

The Act deals with these problems through the authority provided in its various sections. In general, the Act provides for the simplification of utility holding company financial structures and attempts to prevent future abuses of the holding company device by restricting certain actions of companies subject to the Act. It is worth emphasizing that the intent of the PUHCA is to promote effective state regulation of electric and gas utility companies. It is not intended to replace state regulatory authority with federal jurisdiction.

The major authority of the SEC to limit or control the actions of utility holding companies is contained in Sections 9 through 13 of the Act. Section 9 prohibits registered holding companies from acquiring securities or assets of other utilities or any other business unless the acquisition has been approved by a state commission, or the SEC determines that such acquisition is not detrimental to the public interest or the interest of investors or consumers. Section 10 establishes the terms for SEC approval of such acquisitions. It requires that the registered holding company file an application for approval with the SEC. The Commission must then determine that the acquisition is not detrimental to the public interest nor the interest of investors or consumers, and that the acquisition will serve the public interest by tending towards the economical and efficient development of an integrated public utility system. These provisions do not apply to the acquisition of securities or assets of a public utility operating exclusively outside of the United States.

Section 11 of the PUHCA provides for the simplification of utility holding company systems. It authorizes the SEC to examine the corporate structure of all registered holding companies and their subsidiaries and requires that such companies limit their operations to a single integrated public utility system and to such other businesses that are reasonably incidental or economically necessary or appropriate to the operations of such an integrated system. Exceptions are permitted where the SEC determines that such additional systems cannot be operated as an independent system without the loss of substantial economies, all such additional systems are located in one state or in adjoining states or in a contiguous foreign country, and the continued combination of such systems under the control of a holding company is not so large as to impair the advantages of localized management, efficient operation, or the effectiveness of regulation.

Section 12 places limits and restrictions on registered holding companies with regard to intercompany loans, dividend payments, security transactions, sale of utility assets, solicitation of proxies, and political contributions. Section 13 of the Act provides that any subsidiary company or mutual service company of a registered holding company that performs any service, sales, or construction contract for any associate company within the system do so in an economical and efficient manner at cost fairly and equitably allocated among such companies.

In addition to these enforcement powers, the Act provides for the exemption of utility holding companies and their subsidiaries and affiliates from the provisions of the Act. Section 3 provides for the SEC to grant such exemption for those companies that are:

(1) Predominantly intrastate in character and carry on their business substantially in a single state in which such holding company and every such subsidiary company thereof are organized.

(2) Such holding company is predominantly a public utility company whose operations do not extend beyond the state in which it is organized and states contiguous thereto.

(3) Such holding company is only incidentally a holding company, being primarily engaged or interested in one or more businesses other than the business of a public utility.

(4) Such holding company is temporarily a holding company solely by reason of the acquisition of securities for purposes of liquidation or distribution.

(5) Such holding company is not a public utility and derives no material part of its income, directly or indirectly, from one or more subsidiary companies which are predominantly public utility companies principally operating within the United States.

A company does not need to meet all of these requirements to qualify for an exemption. According to Section 3. qualifying companies are exempt from the Act (except for the provisions of Section 9 requiring both exempt and regulated companies to obtain SEC approval before acquiring additional security interest in public utilities) unless the SEC determines that such exemption is detrimental to the public interest or the interest of investors or consumers. Also. the SEC may revoke such an exemption if it finds that the circumstances that gave rise to the exemption no longer exist.

It is this possibility of revocation of exempt status that the electric utility industry objects to. Industry spokesmen point out that this possibility limits diversification into nonutility activities for fear that the SEC may cause a previously exempt utility to become subject to the full authority of the Act. Also, utilities may be reluctant to form holding companies for the purpose of pursuing nonutility diversification because they would be required to register with, and be subject to regulation by, the SEC or would need to qualify for an exemption under Section 3 of the Act.

Is the PUHCA Still Needed?

In calling for the modification or repeal of the PUHCA, some parties have asserted that the major purpose of the Act, the restructuring of public utility holding companies, has already been accomplished, that the Act is duplicative of other federal and state authority, that most utility holding companies have received exemption from most of the provisions of the Act, and that the Act is unduly restrictive of utility company diversification activities. The last of these assertions will be taken up in the following section of this report. The other assertions deal with the general problem of the continued need for the Act; that is, do the conditions that gave rise to the Act still exist or have events caused its continued enforcement to be unnecessary?

A precise answer to this question would require a detailed review of all applicable federal and state statutes pertaining to regulated public utilities. This type of review is beyond the purposes of this report. There is, however, general agreement as to the lack of uniformity in utility regulation at the state level. Additional observations and conclusions regarding this issue, based upon available information, are presented below.

There is little, if any, doubt that under the authority of the Act, the SEC has effected the restructuring of the utility industry into one composed of single-integrated systems and geographically-integrated holding companies. The SEC has also accomplished the simplification of utility holding company financial structures by eliminating unnecessary layers of ownership and control.

This restructuring has been accomplished by SEC authority, provided by the Act, to cause divestiture of assets unrelated to public utility operations, to approve mergers and acquisitions, and to simplify unnecessarily complicated financial structures. This type of oversight of holding company activities, which is intended to control the size and geographic diversification of utility operations in order to promote effective state regulation of other aspects of the regulatory process such as rates, requires continued SEC supervision of holding company operations. For even though a major restructuring of the industry has been accomplished, if such authority is repealed activities can take place which may erode past accomplishments.

In regard to its authority to affect the size and structure of utility holding companies as provided by the PUHCA, the SEC has stated that:

> The standards affecting the size and structure of electric or gas utility companies, such as the definitions of an integrated system in Section 2(a)(29), are couched in qualitative economic terms and expressly refer to relevant current conditions. Accordingly, such standards are not subject to obsolescence.[7]

With regard to the duplication of other federal and state authority, it is worth noting that Congress passed the PUHCA in 1935 after the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934. This ordering of events implies that the Congress felt that the previous acts did not effectively deal with the problems associated with public utility holding companies. Also, the 1933 and 1934 acts are primarily aimed at investor protection, while the PUHCA places primary emphasis on consumer protection and the promotion of effective state regulation of natural monopolies. The unique position of utilities — that of being monopolies that provide essential services to the public — is also worth noting. This presents a problem dealt with in the PUHCA that is not encountered in securities regulation of other types of industries: the separation of utility and nonutility activities, revenues, and costs. However, where duplication of authority can be shown to exist or where restrictions on holding company financial transactions can be shown to be overly burdensome and costly, a strong case for modification of the relevant sections of the Act can be made.

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[7] Securities and Exchange Commission, op cit, pp. 33-34.

As far as state authority over the activities of utility companies is concerned, state regulatory jurisdiction over utility financing and diversification activities varies widely. While all state commissions have the authority to rule on the appropriateness of costs incurred by jurisdictional utilities in providing service, most have limited authority over associated nonutility operations within that state and all lack jurisdiction over activities of utility subsidiary companies operating outside of the state.

In regard to the duplication of authority question, the SEC has stated:

> There is no serious question that the Commission's authority over registered holding company systems subject to the Act is, to a large degree nonduplicative of the authority of state or other federal regulatory bodies.[8]

It should be pointed out that the Commission has recently altered its position on the necessity for continued federal regulation of utility holding companies. SEC Chairman, John S.R. Shad, stated in a December 1981 letter to

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[8] Ibid., p. 24

Senate Subcommittee on Securities Chairman, Alfonse M. D'Amato, that the Commission believes that its task of reorganizing the nation's gas and electric holding company systems under authority of the PUHCA was completed twenty years ago. He also notes that the SEC's administration of the Act in more recent years has primarily involved review of registered holding company financings, merges, and acquisitions and the consideration of requests for exemption. These activities are intended to prevent recurrence of the abuses which led to passage of the Act. However, he states the Commission believes that these abuses are unlikely to recur in light of the extensive changes that have taken place in the public utility and investment banking industries, the accounting profession, state utility regulation, expansion of the disclosure requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934, and the development of more efficient and well-informed securities market. For these reasons, Chairman Shad recommends that the Congress reexamine the underlying premises of the Act to determine the extent to which they have continuing viability today, and should consider repeal of the Act in its entirety.

The NARUC report on nonutility investments also deals with the duplication of regulatory authority issue. The report mentions that at the state level, control over utility financing and diversification activities are for the most part inadequate and vary greatly from state to state.9/ The report states that even though most state commissions have authority to control the disposition of proceeds from the issuance of public utility securities, few have explicit authority to regulate the reinvested earnings of public utilities from their utility operations and even fewer have such explicit authority over nonutility operations. In the case of mergers and affiliations, the NARUC study reports that the pattern of

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9/National Association of Regulatory Utility Commissioners, op cit, pp. 733-734.

state control is similarly incomplete. It is reported that many state commissions have authority to control mergers or affiliations involving utility and nonutility enterprises; however, once the merger or affiliation is completed, further oversight by the state commission is problematical. In this instance, the state commission faces the problem of lack of control over the earnings of unregulated activities which may be employed for further diversification. This in itself is not necessarily a problem, but may contribute to regulatory difficulties as outlined below.

The General Accounting Office (GAO) has also investigated the authority of the PUHCA and the SEC's administration of the Act.10/ In its report to Congress, the GAO states that while there is some overlap of authority between the Act and other federal or state authority, the SEC in large part provdes a nonduplicative type of regulation.11/ The Act empowers the SEC to monitor the operations of utility holding companies and requires them to discontinue certain corporate and financial practices and to divest certain properties. According to the GAO report, states seldom have such broad authority on an intrastate basis, and never on an interstate basis. In addition, the authority of state regulatory commissions varies from state to state. In documenting its position on the nonduplicative nature of PUHCA authority, the GAO report points out that:

(1) State authorities concentrate on rate matters and customer service, areas of regulation in which the SEC does not operate.

(2) Many state authorities lack jurisdiction over unrelated businesses of utility companies within the state, and all lack jurisdiction over such

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10/The Force of the Public Utility Holding Company Act Has Been Greatly Reduced by Changes in the Securities and Exchange Commission's Enforcement Policies, General Accounting Office, Washington, D.C., June 20, 1977.

11/Ibid., p. 7.

out-of-state activities. The SEC exercises authority over nonutility businesses of regulated holding companies.

(3) Most state authorities lack jurisdiction to require corporate reorganization of holding companies and their operating subsidiaries. The SEC, under Section 11 of the Act, has clear authority to do so.

(4) A minority of state commissions are empowered to regulate utility company dividends paid to parent companies. The SEC has such authority under Section 12 of the Act.

(5) The Federal Energy Regulatory Commission (FERC) regulates individual utility companies with regard to wholesale rate matters, and approves financing of some utilities not subject to the Act. It does not have authority to reorganize companies or require divestment of properties.

Utility Companies Exempt from the PUHCA

As reported earlier, Section 3 of the PUHCA provides for exemption of utility holding companies from most of the provisions of the Act. There are currently 12 active holding company systems subject to SEC regulation under the authority of the PUHCA; 10 of these are electric utility holding companies. About 100 other gas and electric utility holding companies have received exemption from SEC regulation. These exemptions, however, are subject to revocation if the SEC finds that the conditions which gave rise to the exemption no longer exist, or the exemption is no longer in the public interest.

SEC administration of the PUHCA has been rather flexibly applied in relation to granting exemptions under Section 3 of the Act. In this regard, the Commission has applied the "functionally related" rule in determining whether to approve new ventures of holding companies subject to its jurisdiction and in determining the appropriateness of diversification efforts of exempt holding companies.[12] The Commission has also suggested guidelines to be used in judging the appropriateness of diversification activities of exempt holding companies. These guidelines are:

(1) All nonutility activities should be segregated from utility activities through separate corporate subsidiaries.

(2) There should be no services, materials, or contracts between the utility and other subsidiaries except to the extent such contracts were subject to the supervision of state regulatory agencies.

(3) There should be no use of utility operating management, funds, or credit for nonutility purposes.

(4) Nonutility investments should constitute only a relatively small component of the entire system.

(5) Activities should be either complimentary in a significant way to the utility operations or have an established and successful (that is, profitable) record for a reasonable period of time.[13]

There has been some criticism of SEC policy in granting exempt status to utility holding companies, due largely to the fact that the majority of such companies have received exemptions. The GAO noted that the SEC has granted exemptions on the basis of geographic location of holding companies without regard to the size of their operations. It also asserted that the SEC has not developed criteria or standards for deciding how large a holding company needs to be to operate efficiently, be easily regulated, and be responsible to the public.[14] The GAO also noted that many exempt holding companies are as large as, or larger than, companies not exempted from the Act and that the SEC does not systematically monitor the business activities of exempt companies. This method of enforcement, it concludes, has resulted in a "double standard" being applied to regulated and exempt holding companies, and has resulted in such contradictive results as exempt companies being permitted to operate both gas and electric utility operations, while nonexempt companies are not permitted to do so.[15]

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[12] Energy Utility Diversification, Holding Companies, and Regulation, by J. R. Malko, G. B. Enholm, nd T. M. Jaditz, Public Service Commission of Wisconsin, Office of Chief Economist, Madison, WI, September 1981, p. 23.

[13] Ibid., p. 23.

The SEC has countered this argument by stating that geographic location is the primary standard for granting exemption under Section 3, and that a company does not have to meet all of the standards of the Act in order to be granted an exemption.[16]

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[14] General Accounting Office, op cit, p. 13.

[15] Ibid., p. 28.

[16] Securities and Exchange Commission, op cit, pp. 19-20.

IV. ELECTRIC UTILITY DIVERSIFICATION

The electric utility industry has increased its interest in diversification activities and in modification or repeal of the PUHCA for a number of reasons. Spokesmen for the industry have noted that electric utilities have suffered the effects of rising fuel costs and general inflation concurrently with inadequate rate relief resulting in reduced and inadequate returns on investment.[17] Coupled with a reduction in sales growth, the industry sees these developments as a major impetus for expansion of activities into nonutility areas of operation.

Other reasons cited for the increased emphasis on diversification activities include:

(1) A company with diversified product lines and customers can better withstand adverse economic conditions, thereby reducing the impact on overall earnings and profitability.

(2) Diversified activities may offer greater earnings potential and sales growth than traditional lines of endeavor.

(3) Diversification may allow a company to more fully utilize its available resources including company management, operating personnel, production and/or distribution facilities, technical expertise, market contacts, and research activities.

(4) Complementary relationships among affiliated companies, such as cash flow, investment opportunities, tax advantages, and unused tax deductions, can be fully utilized.

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[17] Business Diversification - A Strategic Option for the Utility Investor, by Terry A. Ferrar, Edison Electric Institute, Washington, D.C., August 18, 1981, p. 1.

(5) Diversification may improve the company image before investors and the financial community, allowing for easier capital attraction.

(6) Expectation of superior performance following a merger or acquisition may improve stock performance and increase the company's price/earnings and market-to-book ratios.

(7) Diversification may allow the company to better attract and retain qualified management and operating personnel.

(8) Start-up problems for a diversified activity may be minimized by affiliation with an established utility company.

The Edison Electric Institute (EEI) report mentioned that while statistical evidence as to the financial effectiveness of diversification is limited, available data suggest it is worth the careful attention of utility management.[18] The report also states that diversified utilities generally show higher than average price/earnings ratios and market-to-book ratios as compared with non-diversified utilities. It is also mentioned that utilities seeking to diversify must assure that nonutility activities are effectively separated from the utility side of operations so that profits derived from diversified activities cannot be passed through to ratepayers. The report also warns that diversification must not diminish management commitment to providing cost effective, reliable electric service.

A recent survey of investor-owned electric utility companies conducted by the EEI found that a substantial number of utilities have at least one business venture outside of their normal function of supplying electrical energy.[19] The survey requested information from 161 investor-owned electric utilities regarding utility ownership of business ventures "outside the traditional function of generation, transmission, and distribution of electricity." Of these 161 companies, 125 responded, and of these, 79 companies reported that they had at least one such venture.

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[18] Ibid., p. 6.

[19] Investor-Owned Electric Utility New Business Ventures, Edison Electric Institute, Economics Division, Washington, D.C., May 1981.

These 79 companies owned a total of 247 separate business ventures outside of their utility operations. Of this total, 219 are currently operational, 22 are currently planned, and 6 are inactive. Also, of the 247 ventures identified, 143 (58 percent) are subsidiaries, joint ventures, or affiliates of the parent operating company. The remainder are maintained within the corporate structure of the operating company, e.g., a division within the utility.[20] The survey also reports that of the 143 subsidiary ventures, 66 (46 percent) are regulated in terms of service, rates, or finance by either state or federal authorities, or by both. According to the EEI report, the remaining subsidiaries are not subject to regulatory commission authority.

The 247 business ventures cover a wide range of activities. The most predominant types of business ventures found were fuel exploration and development, real estate, energy conservation services, district heating, cogeneration, appliance sales, leasing and service, fuel transportation and transloading, and load management controls. These eight categories comprised 77 percent of all business ventures identified in the survey. Other types of ventures identified include customer billing and collection services, recreation and marina development, energy education services, aquaculture and horticulture, engineering, architectural, and consulting services, solar and renewable energy product sales, synfuels projects, computer software sales, word processing, manufacturing of earth mining and heating equipment, and aircraft sales and maintenance. It should be noted that this extensive diversification activity has taken place even with the PUHCA in force.

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[20] Ibid., p. 6.

Financial Aspects of Electric Utility Diversification

The major benefit of electric utility diversification is purported to be the financial gains derived from improved earnings potential and the resultant reduction in the industry's cost of capital. However, diversification may turn out to be a two-edged sword. The acclaimed financial benefits depend on successful diversification activities. Obviously, there is no guarantee that nonutility activities will be successful or provide a greater return than that derived from utility operations. This is particularly true where such activities involve areas of operation unfamiliar to utility management.

Even if successful, there is no guarantee that the benefits derived from diversification activities will flow to the utility. Management may become preoccupied with the higher profit potential of nonutility activities, and use revenues derived from these activities to further diversify rather than apply them to the less profitable utility operations. There is also the potential for using funds derived from utility operations to support nonutility activities, either successful or unsuccessful, to the detriment of the utility. This is precisely the type of activity that the PUHCA was intended to prevent. And, as already noted, state regulatory commissions have limited and varied authority to deal with such matters.

Industry observers have noted that utility experience with diversification activities have varied. Some utilities believe that management can no longer properly balance the interests of consumers and shareholders without seeking alternative business opportunities. Other utility managements feel that diversification would increase rather than alleviate their problems.[21] Many of these managers believe that they must instead strengthen inadequate earnings in the electric business through a firm commitment to securing prompt and substantial rate relief.

An analysis of the potential financial benefits of electric utility diversification found that these activities may perpetuate the utilities' poor financial performance, rather than help it.[22] According to this analysis, the theoretical justification for diversification is to manage the risk associated with earnings, not necessarily to increase the absolute level of expected earnings. The decision to diversify, then, should be seen as an attempt to control fluctuation or variance in earnings, not to achieve a given long-term average earnings level.

The report notes that investors choose from those potential investments that offer the best return for a given level of risk. If one operation within a diversified firm has returns that are too low for its associated level of risk, the return to the enterprise as a whole will be unattractive to investors. That is, the consolidated return to the enterprise after diversification will always be too low for the associated risk. Thus, rather than helping to solve the problem of inadequate returns to utility investment, diversification merely serves to hide the problem. By spreading the deficiency in returns from utility operations over a larger amount of equity, diversification increases the average return. As a result, utility stocks initially rise in value, owing to the higher average returns on equity. However, while the average shortfall in earnings is reduced, the total shortfall is not. The diversified set of investments will still have the same shortfall of returns for its given level of risk.

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[21] Lehman Brothers Kuhn Loeb Research, op cit, p. 22.

[22] "The View from Hagler Bailly," Hagler, Bailly & Company, Inc., New York, No. 1, 1982.

As a result, the direct benefit of utility diversification is illusory. Ultimately, the diversified enterprise will find that the low utility returns will force down the average return to the enterprise, causing it to pay more for debt and equity in all its activities than its competitors at the same level of return (but not the same level of risk). As a result, its competitive position in the market is undermined. The only alternative to the diversified firm, then, is to raise the return on its less profitable utility operations or divest itself of these investments. At the same time, regulators may perceive the short-term rise in value of utility securities as a sign that the return on investment is adequate. Therefore, they may be loath in granting additional rate relief, thus perpetuating inadequate returns to the electric utility industry.

The above discussion confirms our belief that, if utilities are suffering inadequate returns on investment, the best way to deal with this problem is directly through additional rate relief rather than indirectly through diversification activities. The latter, while perhaps achieving short-term improvement in average returns to the industry, is more likely to contribute to its long-term problems.

Recent developments in the electric utility industry point to the validity of the above analysis. Business Week reported that in November 1981, Central Louisiana Energy Company, a diversified energy concern, divested itself of its electric utility subsidiary, Central Louisiana Electric Company.[23] The reason given for the divestment was the damper on total corporate rate of return resulting from inadequate returns to the utility's operations. The move put the electric utility company back where it was nearly thirty years ago, as a pure power generating utility. The spin-off culminated an eight-year effort by the parent company to assure that profits from its oil, gas, and pipeline operations could not be attached by state regulators eager to keep electric rates low for customers. According to the article, the electric utility was earning about 13 percent on equity, while nonutility operations produced returns around 40 percent.

The NARUC report on utility diversification also dealt with these financial issues and reached essentially the same conclusions. In regard to the supposed reduction in cost of capital due to the greater earnings growth potential of diversified activities, the report concludes that even in the case of successful diversification, the available evidence suggests that diversification increases rather than decreases the cost of capital to the enterprise. This is due to the fact that earnings from nonutility sources are riskier than those of utility operations.[24] It also notes that diversification does not provide guaranteed returns, since success depends upon both the skill of management and good or bad fortune attending various risky ventures. In general, therefore, the utility customer has everything to lose and little to gain through utility diversification. In addition, society is not made better off since those areas into which utilities diversify are no longer available to other corporate enterprises.

The argument regarding diversification of risk is similarly addressed. The report states that it is not clear that successful diversification, even if beneficial to the investor, will be helpful to the utility consumer. The assumption here is that a successfully diversified company earning profits on nonutility operations will invest those profits into an unprofitable utility operation. "Stated this way," the report concludes, "the whole idea is business and financial nonsense, and examples can be found in the history of the railroads and more recently in the activities of Western Union, to support the proposition that businessmen are not anxious to support a losing operation whether or not they are making money on other operations."[25]

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[23] Business Week, December 14, 1981, pp. 132-133.

[24] National Association of Regulatory Utility Commissioners, op cit, p. 721.

It should be noted that the NARUC has initiated a second study of utility diversification activities. This report, due to be completed in July 1982, will reexamine many of the issues dealt with in the 1972 study to determine if the conclusions reached in that report remain valid today. These issues include the necessity for continuation of the authority of the PUHCA and the ability of state commissions to effectively regulate diversified utility companies.

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[25] Ibid., p. 724.

V. UTILITY DIVERSIFICATION AND EFFECTIVE REGULATION

One of the major reasons for enactment of the PUHCA was to promote effective state regulation of utility companies. It has already been mentioned that state regulatory commissions have limited and diverse authority to deal with corporate and financial issues relating to diversified utility companies. However, electric utility diversification presents state regulators with several specific problems.

The study of utility diversification conducted by the Wisconsin commission notes that regulatory interest in utility diversification stems from the requirement of regulators to protect the public interest. The need for regulatory involvement depends upon the form of organization chosen by the utility. An internal utility function is subject to full commission oversight, and a utility subsidiary engaged in utility-related business is very similar to internal utility operations. Once the utility establishes subsidiaries in unrelated business, however, state authorities will not have the same degree of familiarity with the new business venture. A utility holding company established with the intention of pursuing significant diversification can create a situation where the state commission may be unable to effectively deal with nonutility activities without a substantial increase in its authority and staff resources.[26]

The report also mentions that if diversified activities are a significant part of total operations, or are expected to become so, the likelihood of cross-subsidization between regulated and nonregulated activities, adverse impacts of business failure, and difficulty of effectively determining the utility's cost of capital increases substantially. The report notes that in some jurisdictions, state commissions have legal authority to regulate transactions by a utility with an "affiliated interest." However, without such authority, state commissions must rely upon conditions established upon SEC approval of formation of the utility holding company (e.g., utility agreement to provide the state commission with all relevant financial information) to effectively regulate the diversified utility.[27]

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[26] Public Service Commission of Wisconsin, op cit, p. 38.

The report concludes that a holding company structure provides the utility management with substantial freedom of action but presents the state commissions with considerable uncertainty. A holding company can operate subsidiaries in almost any business (absent PUHCA authority) and the utility can become a guaranteed customer in order to increase the likelihood of success of the venture. Acquisition of existing companies is more readily accomplished with a holding company structure, as is external financing, and a continued internal flow of dividends is maintained. Also, regulatory oversight of nonutility activities is minimized or avoided. However, regulators must be concerned with the possibilities of holding company activities endangering the utility's financial position, of being improperly charged for goods and services provided by other subsidiaries, or being required to share the losses on diversified ventures. Regulators, thus, must consider the consequences of energy utility diversification and adopt a regulatory strategic plan to deal with this issue.[28]

The NARUC report reached similar conclusions. While it found that for economic and social reasons the operation of utilities in related fields of endeavor is not only desirable but probably unavoidable, diversification into unrelated activities poses several problems for state regulators. These include cost allocation problems and difficulty in computing the utility's cost of capital.[29]

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[27] Ibid., p. 41.

[28] Ibid., p. 62.

The report notes that a more subtle problem, but one with more serious implications, involves the relationship between the regulated company and the regulatory commission. Absent diversification, the relation is one of mutual dependency. The company needs the support of the commission to obtain revenue required to provide adequate service; and the commission recognizes that unless such revenues are forthcoming service is likely to be impaired.

This situation changes drastically when the regulated company achieves significant diversification. The company is no longer dependent solely on the commission for its revenue and may choose to render less than adequate service if returns to utility operations are perceived as too low. On the other side, the commission may be moved to irresponsible decisions on the premise that if the company fails to derive adequate revenues from the regulated service, it can always rely on its unregulated activities for funds. In either case, a cross-subsidization between regulated and nonregulated activities takes place.

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[29] National Association of Regulatory Utility Commissioners, op cit, p. 732.

VI. SUMMARY AND CONCLUSIONS

The previous discussion points out several important matters to be considered in establishing an ELCON position with respect to modification or repeal of the PUHCA. These include:

(1) The PUHCA was imposed to correct various abuses of the utility holding company device, prevent their recurrence, and promote effective state regulation of utilities. These abuses include inadequate disclosure of financial information, unsound financial practices, excess charges for services provided by subsidiary companies, and extension of utility holding company systems without regard to economies of operation or integration of facilities.

(2) The PUHCA provides for SEC regulatory efforts to simplify financial structures of utility holding companies, prevent unsound business practices, provide adequate disclosure of financial information, eliminate excessive charges for subsidiary-provided services, confine holding companies to a single, integrated utility system, limit the use of utility derived funds for nonutility investments, and restrict intercompany loans, dividends, security transactions, and other financial transactions.

(3) Section 3 of the Act provides for exemption of holding companies from most provisions of the Act based, primarily, on the geographical integration of operations. Currently, the majority of utility holding companies have received exemptions subject to SEC revocation if it is determined that the exemption no longer serves the public interest.

(4) Restructuring of the industry and simplification of its financial structure have substantially been accomplished under authority of the

Act. However, preservation of past accomplishments and prevention of possible future abuses may require surveillance of utility holding company operations.

(5) Authority granted the SEC under provisions of the Act appears to be primarily nonduplicative of other federal and state authority. State regulatory authority over utility diversification activities is limited and diverse. Where such authority can be shown to be duplicative or unduly restrictive of utility holding company financial transactions, a strong case for modification of the Act can be made.

(6) Considerable diversification by electric utilities has taken place, mainly in areas related to utility operations.

(7) Alleged financial benefits to utilities derived from nonutility diversification is unsubstantiated, and evidence indicates that such activities may contribute to the long-term problems of the industry.

(8) If the primary reason for nonutility diversification is inadequate returns to utility operations, as the industry alleges, this problem should be dealt with directly through the granting of additional rate relief rather than indirectly through nonutility diversification.

(9) Extensive nonutility diversification causes difficulties for state regulators in protecting utilities from unsuccessful nonutility activities, separation of costs and revenues, determination of the utility's cost of capital, and possible misuse of utility funds and assets.

(10) Regulators need to prevent holding company financial and operating abuses rather than deal with such occurrences after they take place. Proper administration of the PUHCA provides for continued monitoring of utility holding company activities required to prevent such abuses.

The major reports dealing with the purposes of the Act and the need for its continued enforcement reach substantially the same conclusions. The GAO report recommends that the SEC authorize a study of developments in the gas and electric utility industries to evaluate the individual standards of the Act to determine their continued usefulness.[30] The report also states that the purpose of the Act is not to seek out and punish offenders but to prevent the occurrence of abuse. From this point of view, the absence of demonstrated past harm is not decisive so long as the potential for abuse exists.[31]

The NARUC report recommends that state regulatory agencies seek adequate authority to control utility diversification if they do not already have such power. This authority should include control over disposition of proceeds of securities issues of public utilities, control over investment of utility funds in nonutility enterprises, control over merger or affiliation of public utilities with nonutility enterprises, and power to order severance of nonutility from utility operations when it is in the public interest to do so.[32] The report also recommends that utility companies should continue to be subject to the PUHCA where they are components of public utility holding company systems. Also, the exemptions of presently exempt holding companies should be reexamined and, if necessary to prevent improper diversification, should be revoked.[33]

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[30] General Accounting Office, op cit, p. 17.

[31] Ibid., p. 31

[32] National Association of Regulatory Utility Commissioners, op cit, p. 734.

[33] Ibid., p. 735.

ELCON's Position

In light of the available evidence, it seems proper that ELCON oppose repeal of the PUHCA, unless evidence can be presented to show that the authority of the Act is substantially duplicated by other federal or state statutes. Currently available information indicates that this is not the case. However, those sections of the Act that are duplicative of another authority or unnecessarily restrict the financial transactions of registered holding companies should be reviewed and modified or repealed, if necessary.

The current provisions of the Act provide for continued surveillance of utility company operations which appears necessary to prevent possible abuse of the holding company device.

Electric utility diversification into many areas related to utility operations is permitted under the Act and has taken place. Substantial utility diversification into nonutility-related areas is fraught with dangers and may contribute to the long-term problems of the industry.

If the major impetus for electric utility diversification is inadequate returns to utility investments, as the industry suggests, this problem should be dealt with directly through efforts to secure additional rate relief rather than indirectly through nonutility diversification.

There is no evidence that electric utility diversification into nonutility activities will benefit the industry's investors or customers. Diversification does not improve earnings to utility operations any may subject those earning to increased risk. Also, society in general does not appear to benefit since these activities may be provided by nonutility companies as well as by utilities. Utility intrusion into these areas limits the ability of other companies to expand into new lines of business.